Singapore CA Qualification

Financial Reporting
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The Singapore Accountancy Commission

On 1 April 2013, the Singapore Accountancy Commission (SAC) was formally established as a statutory body of the Singapore Government. It was tasked to achieve a number of far-reaching objectives, spelled out by the ten recommendations in the Committee to Develop the Accountancy Sector report. One recommendation was the launch of a globally recognised qualification, Chartered Accountant of Singapore, also known as CA (Singapore).

The Singapore CA Qualification (formerly known as the Singapore QP) is one of the key initiatives in the SAC's drive to transform Singapore into a leading global accountancy hub for the Asia-Pacific region by 2020.

Designed to maximise the opportunities for those seeking global recognition and international portability, the Singapore CA Qualification is based on programmes offered by leading professional accountancy bodies in established jurisdictions such as Australia, Hong Kong, New Zealand and the United Kingdom.

Lending further distinction to the Singapore CA Qualification is the incorporation of professional accountancy requirements of the Asia Pacific region, taking into account the diverse socio-economic and regulatory profiles of countries in the region. The Singapore CA Qualification also meets international education standards issued by the International Accounting Education Standards Board of the International Federation of Accountants.

About the Institute of Singapore Chartered Accountants

The Institute of Singapore Chartered Accountants (ISCA) is the national accountancy body of Singapore. ISCA's vision is to be a globally recognised professional accountancy body, bringing value to our members, the profession and wider community. There are over 32,000 ISCA members making their stride in businesses across industries in Singapore and around the world.

Established in 1963, ISCA is an advocate of the interests of the profession. Possessing a Global Mindset, with Asian Insights, ISCA leverages its regional expertise, knowledge, and networks with diverse stakeholders to contribute towards Singapore's transformation into a global accountancy hub.

ISCA is the Administrator of the Singapore CA Qualification and the Designated Entity to confer the Chartered Accountant of Singapore – CA (Singapore) – designation.

ISCA is a member of Chartered Accountants Worldwide (CAW). CAW brings together 12 chartered accountancy bodies connecting and representing the interests of over 1.7 million members and students globally.

For more information, visit www.isca.org.sg.
Introduction

This is the sixth edition of the Financial Reporting Textbook of the Singapore CA Qualification.

The Singapore CA Qualification is a post-university accountancy qualification programme with three main components:

- Academic Base
- Professional Programme
- Practical Experience

The inter-relationships between these components are shown in the following diagram.

The Professional Programme aims to equip Candidates with the knowledge, skills and professional values that are required of a Chartered Accountant of Singapore. It is a self-study programme that offers flexibility and learning support to suit the individual study and working needs of each Candidate. The Ethics and Professionalism module is a pre-requisite for all the technical modules. The technical modules may be attempted in any sequence, and only upon completion of the Ethics and Professionalism module and passing all four technical modules will a Candidate be eligible for the Integrative Business Solutions module. Together, the following modules make up the entirety of the Professional Programme:

- Ethics and Professionalism
- Taxation
- Financial Reporting
- Assurance
- Business Value, Governance and Risk
- Integrative Business Solutions

Recommended Progression

The Ethics and Professionalism module must be completed before enrolment in any technical module. There is no other pre-requisite in the Professional Programme for this module.

Module Assessment

Each technical module in the Singapore CA Qualification is assessed by way of a written end-of-module examination that accounts for 100% of a Candidate's final grade. For more information, please refer to the Candidate Handbook on the Singapore CA Qualification website: www.SingaporeCAQualification.com

Module Objective

Upon completion of the Financial Reporting module, Candidates will be able to demonstrate knowledge and apply the Singapore Financial Reporting Standards (International) (SFRS(I)) to produce a complete set of financial statements for an entity. They will also be able to explain and advise on the application of the SFRS(I), demonstrating appropriate professional judgment in the process.

Cognitive Levels

This document includes learning outcomes which Candidates are expected to achieve. Each learning outcome is identified with a cognitive level ranging from 1 to 3. The cognitive levels are described below.

Cognitive level 1

An ability to communicate sound knowledge and insight in relation to emerging trends, current issues, and regulatory changes, with some practical application.

Cognitive level 2

An ability to analyse and apply knowledge to moderately complex scenarios that a Candidate would be likely to encounter in the workplace to derive the best possible outcome.
Cognitive level 3

An ability to demonstrate an elevated level of application of knowledge, as well as synthesise and evaluate information in more complex scenarios in order to arrive at value-added solutions.

This cognitive level gives an indication of the intellectual depth which Candidates are expected to achieve.

The technical modules in the Professional Programme are designed at postgraduate level and build on knowledge, skills and values achieved during the prior tertiary studies. The technical modules are designed to develop higher order skills of application, analysis, synthesis and evaluation. For this reason, there are very few learning outcomes with cognitive level 1.

The following is a mapping of the Module Syllabus to the respective chapters in the Textbook.
# Module Syllabus

## Learning Outcomes

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<th>Learning outcome</th>
<th>Cognitive level</th>
<th>Chapter where covered</th>
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<td><strong>FINANCIAL REPORTING FRAMEWORK</strong></td>
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<td><strong>Objectives of Financial Reporting</strong></td>
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<td>Understand the role of financial reporting in the decision making process of various stakeholders.</td>
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<tr>
<td>Identify stakeholders in the financial reporting process.</td>
<td>2</td>
<td>1</td>
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<tr>
<td>Explain general-purpose financial statements to stakeholders.</td>
<td>3</td>
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</tr>
<tr>
<td>Identify and explain the different stakeholders’ roles in public sector financial reporting.</td>
<td>2</td>
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<tr>
<td><strong>Standard Setting Process</strong></td>
<td></td>
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<tr>
<td>Explain the process adopted by the International Accounting Standards Board (IASB) in issuing new accounting standards or amending existing standards.</td>
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<tr>
<td>Explain the mandate of the Singapore’s Accounting Standards Council (ASC).</td>
<td>2</td>
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<td><strong>The Conceptual Framework for Financial Reporting</strong></td>
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<tr>
<td>Discuss the use of a Conceptual Framework in the setting of accounting standards.</td>
<td>2</td>
<td>3</td>
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<tr>
<td>Apply the principles of the framework to recommend an accounting treatment for a transaction not covered by an extant accounting standard or a proposed new standard.</td>
<td>2</td>
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<tr>
<td>Identify the relationship between accounting theory and practice.</td>
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<td><strong>Regulatory Requirements</strong></td>
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<td>Explain the additional reporting requirements for entities listed on the Singapore Exchange insofar as these go beyond compliance with SFRS (I).</td>
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<tr>
<td>Recognise and apply the legal requirements of Companies Act Cap 50 relating to the preparation of statutory financial statements of an entity, including the circumstances where an entity is required to prepare and present statutory financial statements.</td>
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<tr>
<td>Explain the filing requirements for all entities in Singapore other than the requirements to file tax returns.</td>
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<td><strong>The International Context</strong></td>
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<td>Understand the issues relating to the convergence/non-convergence of accounting standards.</td>
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<td>Appreciate the key differences between IFRS and domestic accounting standards in Asia.</td>
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<td><strong>Reporting and Disclosure</strong></td>
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<td>Explain and analyse the purposes of the annual general meeting and extraordinary general meetings for information exchange between the board of directors and shareholders.</td>
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<td>Learning outcome</td>
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<td>Chapter where covered</td>
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<td>Compliance and Ethics in Financial Reporting</td>
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<td>Assess the relevance and importance of ethical and professional issues in</td>
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<td>complying with accounting standards.</td>
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<td>Appraise the potential ethical implications of professional and managerial</td>
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<td>decisions in the preparation of financial reports.</td>
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<td>Appraise, discuss and recommend an appropriate course of action arising</td>
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<td>from ethical dilemmas in financial reporting.</td>
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<td>Assess the consequences of not upholding ethical principles in the</td>
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<td>Measurement and Reporting</td>
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<td>Apply, explain and evaluate accounting standards for major classes of assets,</td>
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<td>insofar as they affect initial recognition, measurement (including initial</td>
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<td>de-recognition from an entity's statement of financial position.</td>
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<td>Evaluate the measurement bases adopted by accounting standard setters</td>
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<td>and explain different methods of measurement used for major classes of assets.</td>
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<td>classes of assets under the relevant accounting standard appropriate to that</td>
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<td>class of asset.</td>
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<td>Allocate impairment losses for a cash-generating unit.</td>
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<td>• Inventory;</td>
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<td>• Property, plant and equipment;</td>
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<td>• Investment property;</td>
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<td>• Goodwill and other intangible assets; and</td>
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<td>• Assets held for sale.</td>
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<td>Measurement and Reporting</td>
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<td>9, 11, 12, 13, 14</td>
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<td>Apply, explain and evaluate accounting standards for major classes of liabilities, insofar as they affect initial recognition, measurement (including initial measurement and subsequent re-measurement), classification and disclosure, and de-recognition from an entity’s statement of financial position.</td>
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<td>Evaluate the measurement bases adopted by accounting standard setters and explain different methods of measurement used for major classes of liabilities.</td>
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<td><strong>Specific Applications</strong></td>
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<td>Apply the relevant accounting treatment on the following classes of liabilities:</td>
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<td>• Leases and contracts with the characteristics of leases;</td>
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<td>• Income tax;</td>
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<td>• Provisions and contingencies; and</td>
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<td>• Employee benefits.</td>
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<td><strong>RECOGNITION OF REVENUE AND EXPENSES</strong></td>
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<td>Revenue Recognition</td>
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<td>Apply and explain the rules for income recognition and deferral, including:</td>
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<td>• Combination of contracts;</td>
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<td>• Unbundling of physical and service elements; and</td>
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<td>• Deferred, variable and contingent consideration.</td>
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<td><strong>Share-Based Payment Transactions and Arrangements</strong></td>
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<td>Apply and discuss the recognition and measurement criteria for share-based payment transactions and arrangements.</td>
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<td>Account for modifications, cancellations and settlements of share-based payment transactions and arrangements.</td>
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<td><strong>FINANCIAL ASSETS AND FINANCIAL LIABILITIES</strong></td>
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<td>Principles of Financial Instruments Reporting</td>
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<td>Apply, discuss and explain the recognition and de-recognition of financial assets and financial liabilities.</td>
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<td>Apply, discuss and explain the classification of financial assets and financial liabilities and their measurement and disclosure.</td>
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<td>Apply, discuss and explain the treatment of gains and losses arising from financial assets and financial liabilities.</td>
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<td>Apply, discuss and explain the treatment of impairment of financial assets.</td>
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<td>Derivatives and Hedging</td>
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<td>Account for derivative financial instruments and simple embedded derivatives.</td>
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<td>Outline the principles of hedge accounting and account for fair value hedges and cash flow hedges including hedge effectiveness.</td>
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<tr>
<td>Explain the importance of documentation of purported hedging transactions for the purposes of applying hedge accounting.</td>
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## Learning outcome

### OTHER STANDARDS ON PRESENTATION AND DISCLOSURE OF FINANCIAL STATEMENTS

#### Foreign Currency Transactions
- Apply and explain the rules for determination of an entity's functional currency.
- Apply the rules for recording and reporting foreign currency transactions for a single entity, other than for hedging transactions.

#### Earnings per Share
- Apply and explain the rules for reporting basic and diluted earnings per share, including where multiple potential ordinary shares are in existence.
- Apply and explain the rules for disclosure of alternative measures of earnings per share.

#### Operating Segment
- Determine the nature and extent of reportable operating segments.
- Specify and discuss the nature of operating segment information to be disclosed.

#### Events After the Reporting Date
- Apply and explain the accounting and disclosure for events after the reporting date.
- Determine and report going concern issues arising after the reporting date.

#### Related Parties
- Identify the parties considered to be related to an entity.
- Identify the implications of related party transactions and the need for disclosure.

#### Interim Reporting
- Outline the interim reporting requirements under the applicable accounting standards.

#### Equity and Other Comprehensive Income
- Apply the accounting, disclosure and presentation requirements for equity and other comprehensive income components.

### CONSOLIDATED FINANCIAL STATEMENTS

#### Foreign Operations
- Outline and apply the translation of foreign operations into the group's presentation currency.
- Account for the consolidation of foreign operations and their disposal.
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<th>Learning outcome</th>
<th>Cognitive level</th>
<th>Chapter where covered</th>
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<td><strong>Group Accounting</strong></td>
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<tr>
<td>Identify and outline:</td>
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<tr>
<td>• The circumstances in which a group is required to prepare consolidated financial statements; and</td>
<td></td>
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<tr>
<td>• The circumstances when a group may claim an exemption from the preparation of consolidated financial statements.</td>
<td></td>
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<tr>
<td>Apply and discuss the criteria used to distinguish between a subsidiary and an associate.</td>
<td>3</td>
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<tr>
<td>Apply the method of accounting for business combinations including the accounting for non-controlling interests.</td>
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<td>26, 28</td>
</tr>
<tr>
<td>Apply the principles in determining the fair value of consideration transferred.</td>
<td>3</td>
<td>25</td>
</tr>
<tr>
<td>Apply the recognition and measurement criteria for identifiable acquired assets and liabilities and goodwill including situations where business combinations are achieved in stages.</td>
<td>3</td>
<td>25, 29</td>
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<tr>
<td>Determine and apply appropriate consolidation procedures to be used in preparing group financial statements, including statements of cash flows.</td>
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Reading the Textbook and using the Practice Workbook

Now that you are familiar with the Module Objective and the Learning Outcomes (syllabus), you have a better understanding of the learning journey ahead of you. Before you begin reading the Textbook, you should look at the Learning Outcomes listed at the beginning of each chapter, as these statements indicate the key takeaways from the chapter and will help you to focus your reading efforts. As you read each section in the Textbook, it is essential that you also read the relevant section(s) from the applicable Codes, Standards, Statutes, Regulations, and Guides. This will help you to reinforce the key concepts.

At the beginning of most chapters you will also find a list of additional essential reading that will further supplement your learning. Remember, the Textbook is a starting point only, not a comprehensive document. You are required to read widely and to keep up-to-date with the latest developments.

Each semester is approximately 13 weeks long. You should establish your own detailed study plan that fits in with your work and other commitments. There are two distinct periods during the semester that you should take note of i) gaining knowledge and developing your application skills and ii) revising for the examination, which includes honing your application skills.

A sample study plan might be to divide the semester into two with:

- The first ten weeks spent gaining knowledge and developing your application skills; and
- The final three weeks spent revising for the examination and doing practice exam questions.

Using this sample study plan, you would then divide the number of Textbook chapters by ten and plan to work through each chapter accordingly. As you complete each chapter, you should also attempt the corresponding question or questions from Section 1 of the Practice Workbook. This approach will help you to establish whether you have comprehended the concepts thoroughly and reinforces the knowledge and skills gained.

Once you have read the entire Textbook, as well as the other suggested reading materials and worked through the topic-specific questions from Section 1 of the Practice Workbook, you should then switch to intense revision mode and start preparing yourself for the examination. Remember, the end-of-module examination is 100% of your assessment and you have to attain a minimum of 50% of the available marks to achieve a pass.

Section 2 of the Practice Workbook provides exam-standard questions with suggested solutions to help you hone your skills. You should attempt each question as if it were part of a real examination, limiting the time allowed to complete, and being brutally honest with yourself when you compare your answer to the answer suggested. As part of your revision, you should refer back to the Textbook and other essential reading material to ensure that you have fully understood the concepts and noted any exceptions.

In terms of time invested, it is recommended that you spend 120 hours on gaining knowledge and developing your application skills (approximately 12 hours a week for the first 10 weeks of the semester). The last three weeks should be devoted to intensive revision and exam practice. At a minimum, you should plan to invest at least 14 hours each week in the three weeks leading up to the examination.

Remember, your investment of time and effort for this module is just a few short weeks for a rewarding professional career that will last a lifetime.

For any technical queries relating to the Textbook, please email ISCA at: SingaporeCAQualification_exam@isca.org.sg.
Chapter features

This Textbook has been designed to provide Candidates with numerous features to assist the Candidates in preparing for the exams.

- **Essential Reading** directs you to information that you will need to synthesise and/or apply in order to successfully complete this module.
- **Important information** highlights issues that you should be aware of, relating to areas currently undergoing change or which are the subject of discussion.
- **Section Introductions** explain how the section fits into the chapter.
- **Key Terms** are the core vocabulary you need to learn.
- **Key Points** are points that you have to know, ideas or calculations that will be the foundations of your answers.
- **Exam Skills** are the key skills you will need to demonstrate in the exam, linked to question requirements.
- **Formulae To Learn** are formulae you must remember in the exam.
- **Examples** show how theory is put into practice.
- **Questions** give you the practice you need to test your understanding of what you've learnt.
- **Case Studies** link what you've learnt with the real-world business environment.
- **Website References** link to material that will enhance your understanding of what you're studying.
- **Section Summaries** allow you to review each section.
- **Flags** highlight key legislation which you should familiarise yourself with.
Examinable documents

The list below indicates the Standards, Statutes, and other documents, which are regarded as examinable for this module.

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## Financial Reporting Standards

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## Statutes and Codes

- The Accountants Act
- The Singapore Accountancy Commission Act
- The Companies Act
- The Companies (Amendment) Act 2014
- The Companies (Amendment) Act 2017
- EP100 The ISCA Code of Professional Conduct and Ethics
PART A
Financial Reporting Framework
In this chapter we introduce the concept of corporate reporting, considering the stakeholders involved in a company, the types of information that they require and the extent to which general purpose financial statements meet these requirements. The key external stakeholders are shareholders. A number of reports other than general purpose financial statements are produced, including sustainability reports, management commentary and corporate governance reports.

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**ESSENTIAL READING**


1 Corporate reporting

**SECTION INTRODUCTION**

Corporate reporting, put simply, is a summary of a company's transactions and its undertakings throughout the reporting period presented in accordance to SFRS(I)s, Listing Rules, Companies Act, Code of Corporate Governance, Income Tax Act, etc., in order to provide information to users and stakeholders of financial statements for decision-making.

There is no exact definition of corporate reporting, however it generally refers to the presentation and disclosure aspects of:

- **Financial reporting** – the financial statements and associated notes
- **Corporate responsibility** – communication about how companies understand and manage their impact on people, other entities, society and the environment. This includes sustainability reporting.
- **Narrative reporting** – contextual and non-financial information that is reported alongside financial information or independently in order to provide a more meaningful understanding of a company's business
- **Corporate governance** – the processes by which companies are directed and controlled
Corporate reporting is aimed at corporate stakeholders, or user groups, including shareholders. In this chapter, we firstly consider who are the corporate stakeholders and what information they require in order to make decisions. We shall also define general purpose financial reports, and consider to what extent these statements meet user groups' information requirements before identifying and analysing other forms of corporate communication including general meetings and written reports.

SECTION SUMMARY

Corporate reporting generally refers to financial reporting, corporate responsibility reporting, narrative reporting and corporate governance reporting. It is aimed at corporate stakeholders.

2 Corporate stakeholders

SECTION INTRODUCTION

There are several corporate stakeholders who are interested in the performance of a particular company for a number of reasons.

Corporate stakeholders include current and potential investors, employees, lenders, suppliers and other trade creditors, customers, the government and its agencies and the public.

2.1 Investors

Investors, or shareholders, are the providers of risk capital. They require information:

(a) To help make a decision about buying or selling shares, taking up a rights issue and voting
(b) About the level of dividends, past, present and future, and any changes in share price
(c) To assess the stewardship of management, i.e. whether management has been running the company efficiently
(d) Which gives an indication of the liquidity position of the company, the company's future prospects, and how the company's shares compare with those of its competitors
(e) To assist with decisions regarding the potential for capital gain versus dividend income

2.2 Employees

Employees need information about the security of employment and their future prospects for jobs in the company. They also take a keen interest in profits as these are likely to influence pay rises. Where employee share option schemes exist, the performance of a company will influence share price and therefore the intrinsic value of options awarded.

2.3 Lenders

Lenders need information to help them decide whether to lend to a company. They will also monitor the value of any assets taken as security, the security of interest repayments, the availability of cash for redemption at the appropriate time and that any loan covenants have not been breached.
2.4 Trade contacts
Suppliers and other trade creditors need to know whether the company will be a good customer and pay its debts.
Customers need to know whether the company will be able to continue producing and supplying goods.

2.5 Government and its agencies
A government's interest in a company may be one of creditor or customer, as well as being specifically concerned with compliance with the laws of the country and the general contribution of the company to the economy.

2.6 General public
The public at large may require information for all the reasons mentioned above, and will take a particular interest in the impact of a company's operations on the local economy, its environmental impact and its contribution to society.

2.7 Analysts
Business analysts require information to provide advice and solutions to address business change.

2.8 Ratings agencies
Ratings agencies rate companies by reference to their ability to pay back amounts owed. Other companies and organisations will make decisions about the creditworthiness of businesses based on the information which ratings agencies produce.

SECTION SUMMARY
Corporate stakeholders include investors, employees, lenders, suppliers, customers, the government, the general public, analysts and ratings agencies. Each user group requires information to assess particular concerns: investors wish to ascertain whether their investment is sound; employees assess job security; lenders and suppliers need to know that they will be paid; customers want to be assured of continued supply; the government is concerned with compliance; and the general public need to assess the impact of a company on the local economy.

3 General purpose financial reports

SECTION INTRODUCTION
General purpose financial reports are prepared in order to meet the information needs of corporate stakeholders.
3.1 What are general purpose financial reports?

The financial statements prepared by companies are intended to serve the needs of many user groups and are therefore regarded as general purpose financial reports. Special purpose financial reports are those reports which meet the specific needs of one user group, however it is not practicable to provide a series of such reports each year. General purpose financial reports are therefore viewed as compromise documents designed to satisfy to a large extent the information needs of a number of user groups.

General purpose financial reports provide information about:

- The financial position of a reporting entity, in the statement of financial position
- The financial performance, in the statement of profit or loss and other comprehensive income
- Historical changes in cash and cash equivalents, in the statement of cash flows

The objective of general purpose financial statements is spelt out in Chapter 1 of the Conceptual Framework for Financial Reporting (the Conceptual Framework). You should ensure that you have a good working knowledge of the contents of the Conceptual Framework. The Conceptual Framework will also be covered in Chapter 2 of this Textbook.

This Textbook covers general purpose financial reports only. It does not cover special purpose financial reports ie those which are prepared in accordance with a special purpose framework.

3.2 Meeting the information needs of stakeholders

Most stakeholders, including investors and lenders cannot demand that reporting entities provide information directly to them and so must rely on general purpose financial reports for the financial information that they need.

General purpose financial reports are aimed specifically at the ‘primary users’, being existing and potential investors, lenders and other creditors. The International Accounting Standards Board (IASB) (and so Accounting Standards Council (ASC)) consider that, in meeting the needs of these primary users, they will also meet most of the needs of other user groups such as employees and customers.

However, general purpose financial reports do not and cannot provide all of the information that the primary users need and therefore it follows that they do not provide for all of the information needs of other stakeholders either.

In particular, general purpose financial statements (in isolation from other qualitative information) do not:

- Show the value of a reporting entity
- Provide sufficiently detailed information for management decision making purposes
- Provide forward-looking information (apart from the going concern assumption)
- Analyse financial information in the context of the financial environment

In certain cases, particular user groups may require a company to provide additional information to them. For example, banks often require a company to produce detailed ‘management information’ on an ongoing basis in order to make and monitor lending decisions.

A company may produce special purpose financial reports for particular user groups, for example it is common in Australia for companies to provide voluntary employee reports (Kent, P., Windsor, C., and Zunker, T., 2011). Voluntary employee disclosures in Australian annual reports applying Ullmann’s stakeholder theory (Accounting and Finance Association of Australia and New Zealand (AFAANZ) Conference. Darwin, Australia).

In other cases users may rely on external information in order to meet their needs, for example they may consider general economic conditions and expectations, political events and climate and industry outlooks.
In addition, most companies accept that user groups, and in particular shareholders, require and expect additional information over and above that provided in general purpose financial reports. These other forms of shareholder-focused reporting are considered in more detail in the next section of the chapter.

**SECTION SUMMARY**

General purpose financial reports are those financial reports which are intended to broadly meet the needs of a wide range of user groups. Such reports concentrate on the ‘primary users’: investors and lenders. It is assumed that in meeting the broad information needs of these user groups, the needs of other user groups are also met. General purpose financial statements do not, however, provide sufficient information to meet all information needs and user groups must rely on other sources of information about a company and the environment in which it operates.

**4 Other forms of reporting**

**SECTION INTRODUCTION**

The ownership and management of most companies are separate and therefore it is extremely important that management communicate with shareholders at general meetings and through the publication of non-financial reports. Integrated Reporting is an important development.

**4.1 Ownership versus management**

When considering corporate reporting and the scale of information that should be provided by a company to the users of its reports, it is important to remember the basic fact that the ownership and management of most companies are separate. One party – the management – runs a company on behalf of another party – the owners.

As we have already seen, general purpose financial reports, including statements of financial position, profit or loss and other comprehensive income and cash flows, do not meet all of the information needs of shareholders or provide them with sufficient information in order to assess the stewardship of management, whom they have entrusted to run their company.

Management of a company will therefore communicate with shareholders in a number of other ways in order to satisfy their information requirements.

**4.2 Communication with shareholders**

Communication with shareholders may take a number of forms including: meetings and reports. Increasingly websites are used as a form of communication, in particular, to publish reports and make announcements.

Meetings are generally required by statute or regulatory bodies; reports may also be required on a mandatory basis, however in many cases they are provided voluntarily by a reporting entity. It is generally the case that investors no longer accept basic reporting which meets regulatory requirements but does not provide a fully transparent view of a company’s health and prospects. There is therefore a certain level of pressure for companies to report voluntarily on a broad set of non-financial measures that help investors better judge performance.
In Singapore all companies must communicate with shareholders under the *Companies Act*, unless exempt from holding an AGM because of its size and composition. Legislation also dictates the timings and the minimum content to be provided.

Amendments made to the *Companies Act* in 2015 and effective in 2016 gave companies greater freedom to use electronic means for their formal communications with shareholders, as long as such a method of communication is stated in the company's constitutional documents. As a result of the amendments, all companies can pass written resolutions by email and send documents and notices to shareholders by electronic means.

Many larger listed companies will have an Investor Relations function specifically to deal with shareholder communication and understand investors' requirements. Principle 15 of the Shareholders Rights and Responsibilities section in the Singapore Exchange (SGX) Rulebooks states 'Companies should actively engage their shareholders and put in place an investor relations policy to promote regular, effective and fair communication with shareholders'.

Listed companies also must comply with the SGX rules in relation to announcing information, for instance, when the information is price sensitive. From 31 March 2017, SGX rules were amended to allow companies to decide on the most appropriate way to communicate with shareholders. As a result listed companies may now use e-communication to transmit annual reports and other documents.

### 4.2.1 Shareholder communication in Singapore

A study carried out by KPMG, CPA Australia and the Singapore CFO Institute in 2013 revealed a need for better shareholder communication in Singapore.

The study included a quantitative analysis of the methods of communication of about 700 listed companies in Singapore and a qualitative analysis of both listed and unlisted companies in Singapore.

It revealed that:

- The preferred method of communication is online
- Communications could be speeded up and be clearer
- AGM notices could be more timely
- CFOs are increasingly the face of investor relations
- Integrated reporting will become a way of life (see Section 4.8)

It also suggested that those companies that excel in communicating see their constituents as participants in a conversation; in other words shareholder communication is a two-way process.

In terms of reaching shareholders, it was found that more than 90% of Singapore companies communicate through their websites; over 75% of those companies with websites have dedicated investor relations pages. Where it exists, the Investor Relations and communications role is, in about 30% of cases, fulfilled by a dedicated investor relations officer. In almost all other cases the role is fulfilled by a Chief Financial Officer (CFO) or other senior manager or director.

A further KPMG study in 2016, commissioned by the SGX considered mainboard-listed companies only. Part of the study related to investor relations and assessed companies against Principle 15 of the Shareholders Rights and Responsibilities section in the Singapore Exchange (SGX) Rulebooks (see above).

It identified the following strengths:

- In 95% of companies, directors attend the general shareholder meeting
- 95% of companies declared that the board established and maintains regular dialogue with shareholders

The following areas were identified as needing improvement:

(a) One third of companies did not disclose whether voting by poll is adopted and less than half announced the results.

(b) 80% of companies did not disclose whether electronic poll voting is adopted.
(c) Over one third of companies did not disclose whether an investor relations policy or protocol is in place (i.e., a mechanism for defining when and how the company engages and communicates with shareholders and stakeholders).

(d) Just 46% of companies disclosed that a dedicated investor relations team or equivalent is in place.

(e) Approximately half of companies disclosed that minutes for the general shareholder meeting will be prepared and are available to shareholders on request.

Generally, large-capitalisation companies indicated a more structured approach to engaging with shareholders with a high frequency of interactions through investor roadshows, conferences, and analyst briefings; small-cap companies mainly engaged with shareholders at the general shareholder meeting.

The study concluded that some aspects of shareholder communication in Singapore still need to be improved by some listed companies. A number of bodies and initiatives have appeared in recent years that promote better relationships. One of these is Investor Relations Professionals Association (Singapore) (IRPAS). This organisation aims to champion investor relations best practice, and as such it runs a professional development program for professionals that engage with investors, and in 2016 launched the International Certificate in Investor Relations. IRPAS also collaborates with other bodies and organisations, such as the SGX, to run events promoting investor relations best practice. Members of IRPAS include large, listed companies, such as CapitaLand Limited and the Keppel Corporation Limited, as well as smaller private companies.

WEBSITE
2013 report:
www.irpas.com

Example
CapitaLand Limited includes details of its Shareholders’ Communications and Investor Relations Policy on its website. The Policy is split into a General Policy, Shareholder Rights, Communications Principles, Communication Strategies, Company Contracts, and Shareholder Privacy. The policy can be accessed at: http://investor.capitaland.com/investor_relations_policy.html

Within the last few years, the Singapore Corporate Awards have been established, supported by the Singapore Exchange. One of the awards provided is for Best Investor Relations, with the winning companies being those which are exemplary role models in Investor Relations practices who often go beyond the mandatory regulatory requirements in quality of disclosure, corporate transparency and fairness in disclosure. The 2018 gold award winners were China Aviation Oil (Singapore) Corporation Ltd, Ascendas India Trust, Centurion Corporation Ltd, and Grand Banks Yachts Limited.

4.3 Shareholder meetings

4.3.1 Annual General Meeting (AGM)

All companies incorporated in Singapore are required to hold an Annual General Meeting (AGM) in each calendar year. The rules applying to AGMs are as follows:

- The first AGM must be held within 18 months of incorporation.
- No more than 15 months may elapse between subsequent AGMs.
- Accounts presented at the AGM must be made up to a date not more than six months before the meeting (listed companies four months).
- Private companies may dispense with AGMs if at a general meeting of the company a resolution to that effect is passed by all members with voting rights.

The purpose of an AGM is to allow management, committee members and officers of a company to explain how they have managed the organisation over the preceding year. Shareholders will also have the opportunity to ask questions and raise issues before voting on the business items on the agenda. At this meeting the company’s annual report and accounts are also presented and a dividend agreed (if appropriate).

As a vehicle for interactive communication with shareholders, the success of an AGM is dependent on whether shareholders attend and whether they choose to speak. It is generally the case that some shareholders, and particularly those with complaints, will attend and are sufficiently vocal to raise issues at the AGM. Many companies encourage attendance by making an AGM a sociable event, providing refreshments and guest speakers.

**Example**

Questions asked by shareholders at Marks and Spencer AGMs cover a wide range of issues. A selection of questions asked in recent years are listed on the Company website and include the following:

- When and how will the clothing underperformance be rectified?
- What is your strategy for ensuring that total shareholder return is maintained and that you rectify the decline in total shareholder return? How does your remuneration strategy ensure that any bonus pay is conditional and on what is important to shareholders, which is share price growth, dividends and total shareholder return, and not obscured by random operational objectives?
- What doesn’t M&S sell a high quality crusty loaf like other supermarkets?
- What does the Board mean by ‘revolutionary change’, as mentioned in the Annual Report?
- Will you be able to maintain the same level of dividend next year?
- Waste – both food and packaging. What is the M&S policy on this?

Answers were provided by the Directors present at the relevant meetings and, if necessary, further investigation was promised. All questions posed and answers provided are published in the Investors section of the corporate website.


60% of all 2014 AGMs in Singapore were held in April and 76% of all April AGMs were held in the last five business days of that month. On Monday 28 April, 51 issuers listed on the Singapore Exchange started their AGMs between 9am and 12 noon. As a result of this clustering, accessibility is reduced for shareholders with interests in multiple entities.
There is now a calendar online for listed companies to indicate tentative annual general meeting (AGM) dates. The Singapore Exchange (SGX) and the Chartered Secretaries Institute of Singapore (CSIS) came up with the service in response to feedback that too many AGMs are clustered around the last two weeks of April. The calendar is hosted on the website of CSIS, previously known as The Singapore Association of The Institute of Chartered Secretaries and Administrators. If AGMs were more evenly spread through the month, investors would be able to attend more meetings to cast their votes, said the local bourse and CSIS in an announcement yesterday.

4.3.2 Extraordinary General Meetings (EGMs)

An Extraordinary General Meeting (EGM) is a meeting of shareholders and management which occurs at an irregular time. These generally take place because there is an issue which requires the input of all investors which is too serious or urgent to wait until the next AGM, such as the removal of a director.

Shareholders must be informed in advance of the purpose of the EGM so that they are prepared to discuss and exercise intelligent judgment. Failure to issue the requisite notice so will invalidate any resolutions made at the meeting. The minimum notice period is 14 days, however to remove a director or an auditor special notice is required of 28 days. The notice period may also be longer if the company's articles state so.

Example

On 5 July 2017, the Company Secretary of Asiatravel.com Holdings Limited issued notice of an EGM to be held on 21 July 2017 for the purpose of considering the proposed issue of convertible notes.

4.4 Non-financial reporting

Financial statements alone are not considered sufficient without an accompanying explanation of the performance. Therefore in addition to the financial statements contained within the annual report, companies may issue a number of non-financial reports, including:

- Sustainability reports
- Management commentary
- Corporate governance reports

The purpose of these reports is to provide stakeholders with additional information to use in their decision making processes. In most cases this non-financial reporting is voluntary, the exception being corporate governance reports in the case of listed companies.

Increasingly, companies are producing integrated reports, which communicate a company's strategy, governance, performance and prospects and how these lead to the creation of value. Such a report, in effect, incorporates financial information and the non-financial reports mentioned above, and links them. Integrated reports are considered in detail in Section 4.8.
4.5 Sustainability reporting

Pressure is mounting for companies to widen their scope for corporate public accountability. Many companies are responding by measuring and disclosing their environmental and social impacts.

Examples of social measures include: philanthropic donations, employee satisfaction levels and remuneration issues, community support, and stakeholder consultation information. Environmental measures may relate to levels of emissions and waste.

The next step beyond environmental and social reporting is sustainability reporting which includes the economic element of sustainability (such as wages, taxes and core financial statistics) and involves integrating environmental, social and economic performance data and measures.

Sustainability reporting is currently voluntary in Singapore, however in August 2010 the Singapore Exchange announced a new policy encouraging its listed companies to disclose their environmental and social impacts. This was followed by the release of the Sustainability Reporting Guide in June 2011, covered in greater detail in Section 4.5.3 below. Despite this, Singapore companies’ take-up of sustainability reporting was described by the SGX Chief Executive as ‘frankly, very slow’, and only a handful of companies adopted it. In 2014, the SGX therefore announced that it intended to make sustainability reporting mandatory for all listed companies. Ahead of implementing this rule, the SGX embarked on a year long study to determine what guidelines should be adopted for sustainability reports. Proposed guidelines were issued in January 2016 and these were finalised in June 2016.

A number of bodies have issued guidance on sustainability reporting, the most important being the Global Reporting Initiative and, in Singapore, the SGX itself. These are discussed in more detail below, followed by explanation of the new SGX guidelines.

4.5.1 The Global Reporting Initiative

The Global Reporting Initiative (GRI) is a long-term, multi-stakeholder, international undertaking whose mission is to develop and disseminate globally applicable Sustainability Reporting Guidelines for voluntary use by organisations reporting on the economic, environmental and social dimensions of their activities, products and services.

The GRI first published the GRI standards in October 2016 with an effective date of 1 July 2018, with the exception of GRI 303: Water and Effluents 2018 and GRI 403 Occupational Health and Safety 2018 which were both published in 2018 and are effective from 1 July 2021. The standards replace their predecessor the Sustainability Reporting Guidelines (G4 Guidelines) which were withdrawn for reports published after 30 June 2018.

There are currently 36 GRI standards, split under four groupings:

1. Universal standards (GRI 101–103), which guide reporters in the use of the standards, reporting contextual information and how material topics are managed;
2. Economic standards (GRI201–206), which are used for reporting material impacts related to economic topics;
3. Environmental standards (GRI 301–308), which are used for reporting material impacts related to environmental issues; and
4. Social standards (GRI 401–419), which are used for reporting material impacts related to social issues.

All entities that choose to apply the standards should refer to the Universal standards and then select those topic specific standards that are relevant to them (as shown in the following diagram).
GRI standards

GRI 101 Foundation
Starting point for using the GRI standards

GRI 102 General Disclosures
To report contextual information about an organisation

GRI 103 Management Approach
To report management approach to each material topic

SELECT FROM

Economic
GRI 201–206
- Economic performance
- Market presence
- Indirect economic impacts
- Procurement practices
- Anti-corruption
- Anti-competitive behaviour

Environmental
GRI 301–308
- Materials
- Energy
- Water and Effluents
- Biodiversity
- Emissions
- Effluents and Waste
- Environmental Compliance
- Supplier Environment Assessment

Social
GRI 401–419
- Employment
- Labour/Management Relations
- Occupational Health and Safety
- Training and Education
- Diversity and Equal Opportunity
- Non-discrimination
- Freedom of Association and Collective Bargaining
- Child Labour
- Forced or Compulsory Labour
- Security Practices
- Rights of Indigenous Peoples
- Human Rights Assessment
- Local Communities
- Supplier Social Assessment
- Public Policy
- Customer Health and Safety
- Marketing and Labelling
- Customer Privacy
- Socioeconomic Compliance
GRI 101 Foundation

GRI 101 prescribes reporting principles for defining report content and reporting principles for defining report quality. They are:

<table>
<thead>
<tr>
<th>Reporting principles for defining report content</th>
<th>Reporting principles for defining report quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>• <strong>Stakeholder inclusiveness:</strong> an entity should identify stakeholders and explain how it has responded to their expectations and interests.</td>
<td>• <strong>Accuracy:</strong> reported information should be sufficiently accurate and detailed for stakeholders to use it to assess performance.</td>
</tr>
<tr>
<td>• <strong>Sustainability context:</strong> an entity shall present its performance in the wider context of sustainability.</td>
<td>• <strong>Balance:</strong> reported information should reflect both positive and negative aspects of performance.</td>
</tr>
<tr>
<td>• <strong>Materiality:</strong> topics covered should reflect significant economic, environmental and social impacts and should be those that influence the assessments and decisions of stakeholders.</td>
<td>• <strong>Clarity:</strong> information should be made available in a manner that is understandable and accessible to stakeholders.</td>
</tr>
<tr>
<td>• <strong>Completeness:</strong> material topics and their boundaries (i.e., where the impact occurs) should be included in the report.</td>
<td>• <strong>Comparability:</strong> information should be reported consistently to allow comparison over time and with other organizations.</td>
</tr>
<tr>
<td></td>
<td>• <strong>Reliability:</strong> reported information can be subject to examination to establish quality and materiality.</td>
</tr>
<tr>
<td></td>
<td>• <strong>Timeliness:</strong> reporting should be regular.</td>
</tr>
</tbody>
</table>

GRI 102 General Disclosures

GRI 102 provides guidance on general disclosures that a reporting entity should make; topic specific disclosures are contained within the topic-specific standards.

<table>
<thead>
<tr>
<th>Topic</th>
<th>Disclosures include:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td><strong>Organisational profile</strong></td>
</tr>
<tr>
<td></td>
<td>The organisation's name, activities, brands, product, location and ownership, as well as details of markets, employees, supply chain, external initiatives and memberships of associations.</td>
</tr>
<tr>
<td>2</td>
<td><strong>Strategy</strong></td>
</tr>
<tr>
<td></td>
<td>Statement from senior decision maker and key impacts, risks and opportunities</td>
</tr>
<tr>
<td>3</td>
<td><strong>Ethics and integrity</strong></td>
</tr>
<tr>
<td></td>
<td>Values, principles, standards, mechanisms for advice and concerns about ethics,</td>
</tr>
<tr>
<td>4</td>
<td><strong>Governance</strong></td>
</tr>
<tr>
<td></td>
<td>Governance structure, executive responsibility for specific topics, conflicts of interest, risk management processes, remuneration policies.</td>
</tr>
<tr>
<td>5</td>
<td><strong>Stakeholder engagement</strong></td>
</tr>
<tr>
<td></td>
<td>List of stakeholder groups, approach to stakeholder engagement, key topics and concerns raised</td>
</tr>
<tr>
<td>6</td>
<td><strong>Reporting practice</strong></td>
</tr>
<tr>
<td></td>
<td>Entities included in group financial statements, material topics, restatements, reporting period, GRI content index, external assurance.</td>
</tr>
</tbody>
</table>
GRI 103 Management Approach

GRI 103 includes general requirements and disclosures for reporting the management approach to material topics. These include:

- **General requirements**
  
  An entity must disclose any material topics for which there is no management approach (and the reasons why not) and any topics that are combined with other topics for the purpose of management approach disclosures.

- **Explanation of the material topic and its boundary**
  
  For each material topic, an entity must state why the topic is material, where the impact occurs and the organisation’s involvement with the impact.

- **Management approach and its components**
  
  For each material topic, an entity must report an explanation of how the topic is managed, a statement of the purpose of the management approach and a description (where relevant) of policies, commitments, goals and targets, responsibilities, resources, grievance mechanisms and specific actions related to a topic.

- **Evaluation of the management approach**
  
  For each material topic an entity must report an explanation of how it evaluates the management approach, and any resulting changes to management approach.

An increasing number of companies are following the GRI principles in their reporting. These companies have the option of obtaining verification of their report rating by the GRI.


4.5.2 Application of GRI guidelines in Singapore

Singapore Compact for Corporate Social Responsibility (Singapore Compact) was formed in 2005 to promote the use of corporate social responsibility in Singapore. In 2015 it was renamed Global Compact Network Singapore (GCNS). It has conducted two studies on the use of sustainability reporting in Singapore, in 2011 and 2013.

The 2011 study found that just 79 out of 592 Singapore-listed companies produced sustainability reports for that year. Of these companies, only six had their reports externally audited and four obtained GRI verification. It was found that sustainability reporting was most common in sectors such as mining and agriculture, which face higher regulatory requirements.

The 2013 study found that 160 out of 537 listed companies in Singapore communicated sustainability. Of these, 19 companies used the GRI framework to produce sustainability reports, 16 submitted their reports to GRI for application checks and 8 had their reports audited externally.

Accountability for a Sustainable Future – Sustainability Reporting in Singapore among Singapore Exchange Mainboard Listed Companies 2013
Both reports retrieved on 8 August 2018 from [www.crsingsapore.org/c/resources/publications](http://www.crsingsapore.org/c/resources/publications)

A further study by the National University of Singapore (NUS) Business School's Centre for Governance, Institutions and Organisations (CGIO) and the Asean CSR Network (ACN) examined mainboard-listed companies that disclosed information in the two years from 1 January 2014 and found that just 186 of the 502 companies covered communicated sustainability. Of these, just 15 produced a standalone sustainability report, with the rest incorporating sustainability information in the annual report. The study concluded that the number of companies communicating sustainability in Singapore is increasing, but slowly, and the country still lags behind its regional peers.
According to the Global Reporting Initiative disclosure database, 80 Singapore-based organisations published sustainability reports in line with the previous GRI G4 guidelines since 2016. These companies operate in the real estate, agriculture, tourism and leisure, financial services and logistics sectors amongst others.

City Developments Limited (CDL) prepared a sustainability report in 2016 in line with the GRI G4 Guidelines. Its adherence level was determined to be ‘In accordance – Comprehensive’. The following extract is taken from the 2016 report.

Example

A short section of CDL’s sustainability report is reproduced below. This extract is drawn from the section of the report which considers the alignment of CDL’s material issues with a number of sustainable development goals (SDGs) issued by the United Nations.

<table>
<thead>
<tr>
<th>SDG applicable to CDL</th>
<th>Our Impact and Contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ensure sustainable consumption and production patterns</td>
<td>Through our sustained programmes to engage tenants, homebuyers, youths and members of the public through initiatives such as CDL Green Lease Partnership Programme, “Let’s Live Green” outreach, EcoBank, North West Power Up Scheme, CDL actively advocates sustainable consumption through behavioural changes. We also uphold responsible sourcing along the supply chain through our Green Procurement Guidelines and by setting a target for 35% of our building material to be derived from recycled content, low-carbon sources, or are certified by recognised environmental organisations.</td>
</tr>
<tr>
<td>Take urgent action to combat climate change and its impacts</td>
<td>Since 2008, CDL has established a target to reduce carbon emissions intensity across all our operations in Singapore. In 2015, we advanced our commitment with a Climate Change Policy, and have achieved a 19% carbon intensity reduction from baseline year 2007. We have also implemented a Greenhouse Gas (GHG) management system in line with ISO 14064-1, and have adopted the Sectoral Decarbonisation Approach in reviewing our existing targets in support of Singapore’s climate goals and the COP21 Paris Agreement.</td>
</tr>
<tr>
<td>Sustainably manage forests, combat desertification, halt and reverse land degradation, halt biodiversity loss</td>
<td>CDL has taken steps to ensure the conservation of natural habitats and biodiversity by making it a standard practice during the planning stage of construction to conduct a Biodiversity Impact Assessment (BIA) and consult with environmental NGOs and agencies, where applicable. Moving forward, we are reviewing the implementation of a more rigorous Environmental Impact Assessment (EIA) for CDL’s new developments in 2016.</td>
</tr>
<tr>
<td>Promote just, peaceful and inclusive societies</td>
<td>CDL believes in creating a fair and inclusive society for our business to thrive and prosper in. Our steadfast commitment is evident in our ‘zero-tolerance’ policies and practices towards fraud and corruption, non-discrimination in hiring policy, as well as our corporate stance on human rights prohibiting child and forced labour in CDL’s operations and supply chain. Legal compliance across all our operations is of utmost concern to our business.</td>
</tr>
</tbody>
</table>

4.5.3 SGX sustainability guidelines

In June 2011, in response to the low numbers of Singapore companies reporting on sustainability issues, the Singapore Exchange (SGX) issued its listed companies a new set of guidelines on reporting social and environment impacts on a voluntary basis.

In June 2016, following a consultation period, a new SGX Sustainability Reporting Guide was issued, with the result that all listed companies will need to disclose their sustainability practices or explain why they have not done so (a ‘comply or explain’ basis).

The Guide requires that listed companies issue a sustainability report, in respect of all years ended on or after 31 December 2017. For the first year, reporting entities will have 12 months to issue their report and in subsequent years, reports must be issued within five months of the year end. Independent assurance on the accuracy and completeness of data is encouraged but not mandated.

The sustainability report should describe the reporting entity's sustainability practices in relation to the Five Primary Components:

1. **Identification of material environmental, social and governance (ESG) factors**
   Companies must identify factors in the context of the value chain of the business, give reasons for their choice and describe the selection process, taking into account relevance to business strategy, business model and key stakeholders.

2. **Policies, practices and performance of the company**
   These should be identified in relation to each of the material environmental, social and governance factors, in both narrative and quantitative terms.

3. **Targets**
   Targets for the forthcoming year should be identified in relation to each material ESG factor.

4. **Sustainability Reporting Framework**
   A reporting framework should be selected to guide disclosure; reasons for choosing the framework should be disclosed and a general description of the application of the framework. Acceptance and comparability will be enhanced by use of an internationally recognised or industry-relevant framework.

5. **Board statement**
   A statement of the board confirming that it has considered sustainability issues as part of strategic formulation, determined the material ESG factors and overseen the management and monitoring of the material ESG factors.

If a company does not report on any primary component, it must state so and explain what it does instead and its reasons for doing so.


4.6 Management commentary

A management commentary (sometimes called a business review) is a narrative report that accompanies financial statements as part of an entity's financial reporting.
It explains the main trends and factors underlying the development, performance and position of the entity's business during the period covered by the financial statements. It also explains the main trends and factors that are likely to affect the entity's future development, performance and position. A management commentary should be balanced and not just highlight a company's successes; it should also address risks and issues facing an entity that may not be apparent from a review of the financial statements and suggest how these risks and issues will be addressed.

The IASB issued a Practice Statement on Management Commentary in December 2010, and this was adopted as an FRS Practice Statement 1 by the Singapore ASC in 2011. This is a broad, non-binding framework for the presentation of narrative reporting to accompany financial statements prepared in accordance with Singapore FRS and SFRS(I). It does not, however, mandate which entities are required to publish management commentary, how frequently an entity should do so or the level of assurance to which management commentary should be subjected.

Guidance on the preparation of an operating and financial review, which is similar to management commentary, is provided in the OFR Guide in the SGX LM Practice Note available at: http://rulebook.sgx.com/en/display/display_main.html?rbid=3271&element_id=5626&print=1.

4.6.1 Purpose of management commentary
The purpose of management commentary is to help investors to:

- Interpret and assess the related financial statements in the context of the environment in which the entity operates
- Assess what management views as the most important issues facing the entity and how it intends to manage those issues
- Assess the strategies adopted by the entity and the potential for those strategies to succeed

4.6.2 Principles of management commentary
A number of principles and qualitative characteristics should underlie the preparation and presentation of the management commentary. In particular, the management commentary should:

- Supplement and complement financial statement information
- Provide an analysis of the entity through the eyes of management
- Have an orientation to the future
- Possess the fundamental characteristics of relevance and faithful representation and maximise the enhancing characteristics of comparability, verifiability, timeliness and understandability

4.6.3 Contents of management commentary
The particular focus of management commentary will depend on the facts and circumstances of a company, but it should include information that is essential to an understanding of:

(a) The nature of the business
(b) Management's objectives and strategies for meeting those objectives
(c) The entity's most significant resources, risks and relationships
(d) The results of operations and prospects
(e) The critical performance measures and indicators that management uses to evaluate the company's performance against stated objectives

Practice Statement No 1 does not propose a fixed format as the nature of management commentary varies between entities. It does not provide Application Guidance or Illustrative Examples, as this could
be interpreted as a floor or ceiling for disclosures. Instead, the IASB and Singapore ASC anticipate that other parties will produce guidance.

However, the IASB has provided a table relating the five elements listed above to its assessment of the needs of the primary users of a management commentary (existing and potential investors, lenders and creditors).

<table>
<thead>
<tr>
<th>Element</th>
<th>User needs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nature of the business</td>
<td>The knowledge of the business in which an entity is engaged and the external environment in which it operates</td>
</tr>
<tr>
<td>Objectives and strategies</td>
<td>To assess the strategies adopted by the entity and the likelihood that those strategies will be successful in meeting management's stated objectives</td>
</tr>
<tr>
<td>Resources, risks and relationships</td>
<td>A basis for determining the resources available to the entity as well as obligations to transfer resources to others; the ability of the entity to generate long-term sustainable net inflows of resources; and the risks to which those resource-generating activities are exposed, both in the near term and in the long term</td>
</tr>
<tr>
<td>Results and prospects</td>
<td>The ability to understand whether an entity has delivered results in line with expectations and, implicitly, how well management has understood the entity's market, executed its strategy and managed the entity's resources, risks and relationships</td>
</tr>
<tr>
<td>Performance measures and indicators</td>
<td>The ability to focus on the critical performance measures and indicators that management uses to assess and manage the entity's performance against stated objectives and strategies</td>
</tr>
</tbody>
</table>

(Management Commentary Practice Statement, Basis for Conclusions, para. BC48)

Example

The following short extract of management commentary is taken from the Banyan Tree Holdings Annual Report 2017. This extract deals with one small part of the company's business – its spa operations.


Spa Operations

As at 31 December 2017, the Group's Spa footprint covered 23 countries on four continents. One new outlet in China opened in 2017, with another 9 in the pipeline in China, including Taiwan and Hong Kong, Cuba, Greece and Malaysia for 2018. These additions will grow the Group's portfolio to 69 spas.

Our Spa operations recorded an Operating Profit margin of 13% in 2017. Overall take-up rate increased by 8%. Thailand and South Africa in particular saw a substantial improvement in take-up from in-house guests. To maintain healthy profits, we discontinued two low-performance leased outlets in China and Thailand and three managed outlets in Malaysia and Portugal. These closures, combined with the lower performance recorded by our Maldives outlets due to a decline in tourists from China and Russia, caused revenue to decrease by 7% from the previous year's S$17.6 million to S$16.4 million.

Through the Group's strategic partnerships with AccorHotels and Vanke, we aim for continued growth by launching new outlets in diverse regions and partner networks, as well as leveraging our institutional expertise and accreditations to secure new revenue streams from training partnerships. Our award-winning Banyan Tree Spa Academy was named the Best Quality School 2017 by The Private Education Commission of the Thai Ministry of Education. This recognises our stringent training methodology and accredits out academy as an institution to develop therapists and raise the bar for the spa industry. This was among the 62 awards Banyan Tree Spa won in 2017, bringing the total to 608 to date.
We continue to manage costs prudently, optimise operational efficiency and increase synergy with hotel operations. In addition, we are investing in capability enhancement to enrich our offerings to the growing wellness market and maintain Banyan Tree Spa's position as a leading spa operator. These investments in product innovation are positioned to contribute to the top line and reach out to new markets. They will soft-launch through 2018 and beyond, reinforcing Banyan Tree as a Sanctuary for the Senses and our Spa as quintessential to the guest experience.

Question 1.1 Management commentary

What are the advantages and disadvantages to a corporate entity and the users of its accounts in preparing management commentary?

4.7 Corporate governance reporting

4.7.1 What is corporate governance?

**KEY TERMS**

**CORPORATE GOVERNANCE** is the system by which companies establish a framework for the Board of Directors to provide leadership, exercise its oversight role, promote transparency and integrity in all company dealings, and work with management to achieve long-term sustainable growth and value for the company's shareholders.

**CORPORATE GOVERNANCE REPORTING** is the approach adopted by the Board of Directors to communicate how the company has been managed through the principles of good corporate governance.

Corporate governance has been the subject of much debate in the last three decades; the trigger for this debate was the collapse of major international companies in Europe and the USA during the 1980s and 1990s due to dubious (or even fraudulent) activities by company management.

The events represented a nasty shock for countries such as the UK and the USA, that felt they had well-regulated markets and strong company legislation. It became obvious, however, that part of the problem was the way in which regulation was spread between different national authorities for these global conglomerates, so that no one national authority had the whole picture of the affairs of such companies, nor full powers over the whole of the business.

Individual countries began to develop better guidelines for corporate governance, and these guidelines continue to evolve to the present day. It should, however, be noted that accounting scandals and company collapses continue to exist in Asia as much as in Europe and the USA. Recent examples include:

- The overstatement of revenue and profits by Singapore company Accord Customer Care Solutions, uncovered in 2005 (https://www.wsj.com/articles/SB110927160099363307)
- In 2013 Caterpillar announced it would write US$580 million off the value of a Chinese acquisition after discovering that the firm it purchased did not have much of the inventory listed on its books (http://uk.reuters.com/article/2013/01/19/us-caterpillar-siwei-idUSBRE90H1C520130119)
- In 2015 seven directors of Japanese firm Toshiba resigned, after it came to light that profits had been inflated for a number of years (www.japantimes.co.jp/news/2015/09/18/business/corporate-business/pressure-to-show-a-profit-led-to-toshibas-accounting-scandal/#.VsHFuse5DHg)

The continuing occurrence of accounting irregularities suggests that corporate governance processes are still not sufficiently developed and there are improvements to be made in this area.
4.7.2 The development of corporate governance in Singapore

Corporate governance in Singapore has undergone many changes since 2007, in part due to the many global corporate mismanagement incidents that happened which culminated in the 2008 global financial crisis. While regulators are careful not to succumb to knee-jerk reactions following these events, a gradual process has been undertaken to review many of the existing rules, regulations and guidelines that govern and guide corporate governance practices in Singapore.

In Singapore, the key rules, regulations and guidelines on corporate governance practices include the following (which is not an exhaustive list):

- Listing Rules issued by Singapore Exchange (SGX)
- Companies Act
- Code of Corporate Governance
- Risk Governance Guidance for Listed Boards

As discussed in more detail below, changes to the Companies Act in 2015 have improved the corporate governance landscape, ensuring greater accountability and transparency.

**Listing Rules**

The Listing Rules were revised in September 2011 and seek to strengthen the corporate governance practices of listed companies in Singapore and foster greater disclosure in light of recent corporate failures. Among the key changes were those mandating that the Board and Audit Committee issue opinions on:

- Adequacy of internal controls at the listing stage and in the annual reports
- Competency, character and integrity of the Chief Financial Officer (CFO) at the listing stage

In addition, there are also requirements with regards to announcements to be made in relation to appointment and cessation of independent directors. Directors and key executive officers are now also required to inform the SGX in writing following cessation of their services, whether they are aware of any irregularities in the companies.

The Listing Rules were further amended in August 2018 to reflect amendments to the Code of Governance (see below). Most of the amendments will come into effect on 1 January 2019.

**Companies Act**

The Companies Act was enacted in 1967. It applies to all companies incorporated in Singapore, and contains provisions relating to the life-cycle of companies, from incorporation to management to winding up. The Act also contains some provisions that apply only to listed companies and branches of foreign companies set up in Singapore.

A review of the Companies Act was conducted in 1999 where several key changes were made, such as allowing one-director private companies, removing statutory audit for dormant companies and exempt private companies with annual turnover of less than S$5 million.

Many events in the world have occurred since 1999 and countries around the world have undertaken or completed their own reviews of their company law frameworks and redrafted their company legislation.

In October 2007, the Ministry of Finance (MOF) appointed a Steering Committee to undertake a comprehensive review of the Companies Act. The objectives of the review were to reduce regulatory burden and ease compliance, while retaining an efficient and transparent corporate regulatory framework that supports Singapore’s growth as a global hub for both businesses and investors.

The Steering Committee submitted its final report to MOF in April 2011, containing 217 recommendations relating to directors, shareholder rights, capital maintenance, accounts, company administration and charges. MOF decided to accept 192 recommendations and modify 17 while 8 recommendations were not accepted. The Companies (Amendment) Act was passed by Parliament in October 2014 and the legislative changes that it introduces will be effected in two phases. The first phase will be implemented on 1 July 2015 and the second phase will commence in the first quarter of 2016.
An amendment of particular relevance to corporate governance relates to Chief Executive Officers (CEOs). With effect from the first quarter of 2016 (the second implementation phase of the new Act), CEOs will be required to comply with certain disclosure requirements that are already applicable to directors, including conflicts of interest and their own and their family's interests in shares. This amendment reflects the public perception that CEOs have a key role in company decision making and should be held to the same, or higher, standards of scrutiny than directors. This approach reflects that already adopted for listed companies.

4.7.3 Revised Code of Corporate Governance

The Code of Corporate Governance (the Code) was first issued by the Corporate Governance Committee in March 2001. Compliance with the Code is not mandatory but listed companies are required under the Singapore Exchange Listing Rules to disclose their corporate governance practices and give explanations for deviations from the Code in their annual reports (i.e., a 'comply or explain' approach is taken to the Code).

The Code was revised in July 2005 and again in May 2012. In February 2017, the Corporate Governance Council was established to conduct a comprehensive review of the Code. All of its recommendations were accepted and a further revision to the Code was issued in August 2018, along with accompanying Practice Guidance. The 2018 Code applies to Annual Reports covering financial years starting from 1 January 2019.

The 13 principles contained in the revised Code are:

1. **The Board's conduct of affairs** – every company should be headed by an effective Board which is collectively responsible and works with the Management for the long-term success of the company.

2. **Board composition and guidance** – there should be an appropriate level of independence and diversity of thought and background in the composition of the Board to enable it to make decisions in the best interests of the company.

3. **Chairman and Chief Executive Officer** – there should be a clear division of responsibilities between the leadership of the Board and the Management, and no one individual should have unfettered powers of decision-making.

4. **Board membership** – there should be a formal and transparent process for the appointment and reappointment of directors to the Board, taking into account the need for progressive renewal of the Board.

5. **Board performance** – there should be a formal annual assessment of the effectiveness of the Board as a whole and each of its board committees and individual directors.

6. **Procedures for developing remuneration policies** – there should be a formal and transparent procedure for developing policies on director and executive remuneration and for fixing the remuneration packages of individual directors and key management personnel. No director should be involved in deciding his own remuneration.

7. **Level and mix of remuneration** – the level and structure of remuneration of the Board and key management personnel should be appropriate and proportionate to the sustained performance and value creation of the company, taking into account the strategic objectives of the company.

8. **Disclosure on remuneration** – every company should be transparent on its remuneration policies, level and mix of remuneration, the procedure for setting remuneration and the relationships between remuneration, performance and value creation.

9. **Risk management and internal controls** – the Board is responsible for the governance of risk and should ensure that Management maintains a sound system of risk management and internal controls to safeguard the interests of the company and its shareholders.
10 **Audit committee** – the Board should have an Audit Committee which discharges its duties objectively.

11 **Shareholder rights and conduct of general meetings** – companies should treat all shareholders fairly and equitably, in order to enable them to exercise shareholders' rights and have the opportunity to communicate their views on matters affecting the company. The company should give shareholders a balanced and understandable assessment of its performance, position and prospects.

12 **Engagement with shareholders** – companies should communicate regularly with their shareholders and facilitate the participation of shareholders during general meetings and other dialogues to allow shareholders to communicate their views on various matters affecting the company.

13 **Engagement with stakeholders** – the Board should adopt an inclusive approach by considering and balancing the needs and interests of material stakeholders as part of its overall responsibility to ensure that the best interests of the company are served.

Specific changes brought about by the revisions include the following:

- From 2022, independent directors' tenure will be limited to nine years with any extension to this period requiring a vote from shareholders.
- From 2022, non-executive directors will need to comprise the majority of a board.
- The threshold to qualify as a substantial shareholder will be reduced to 5% of issued share capital from 10%.
- Companies will be required to disclose the criteria for selecting, appointing and re-appointing directors.
- Companies must explain how board and key management personnel remuneration is appropriate and proportionate in the context of the company's performance and value creation.
- A company's audit committee should meet independently with external and internal auditors and without management being present at least annually.
- Proposals at general meetings should not be 'bundled'; instead they should be presented separately and any linkages identified.
- Improved disclosure on board and shareholder communication and a requirements to develop new mechanisms to allow shareholders to contact companies with questions.
- Strengthened policies regarding engagement with stakeholder groups.
- The formation of a Corporate Governance Committee to promote good corporate practice.

### 4.7.4 Risk Governance Guidance for Listed Boards

Global events since the 2008 global financial crisis have underscored the importance of companies taking an integrated, enterprise-wide perspective of their risk exposure. There is heightened concern and focus on risk governance, and it has become clear that companies should have a sound system of risk management and internal controls to identify, assess, manage and mitigate risk. In this regard, the Risk Governance Guidance for Listed Boards (the Guidance) issued in May 2012 is another key initiative by Corporate Governance Council (CGC) to strengthen the corporate governance practices of listed companies in Singapore. The Guidance acts as a complement to the Code and enhances the framework for corporate governance of Singapore-listed companies.

The intent of the Guidance is to provide key information on risk governance to all Board members and provide guidance on the Board's role on risk governance vis-à-vis the Code's Principle 11 on Risk Management and Internal Controls. This include factors which the Board should collectively consider when overseeing the company's risk management framework and policies. Its purpose is to enhance the awareness of Board members, and spur them towards strong corporate governance in their companies.
which will in turn enhance investor confidence and Singapore's reputation as a trusted financial and business hub.


4.7.5 Corporate governance reporting

Boards of directors are responsible for the governance of their companies, while the shareholders' role is to appoint the directors and auditors and satisfy themselves that appropriate governance structures are in place.

In order to do this, shareholders require information about the corporate governance processes within a company. Corporate governance reporting is concerned with providing this information.

A corporate governance report is normally included within the published annual report of listed companies, and will cover such issues as Board composition, senior management remuneration, risk management and communication with shareholders.

Example

China Aviation Oil (Singapore) Corporation Ltd was the 2018 winner at the Singapore Corporate Awards in the Investor Relations category: Companies with $1 billion and above in market capitalisation. The corporate governance report within the company's 2017 annual report is 22 pages long and provides detail on a number of areas including:

- Board matters (including the Board's conduct of affairs, Board composition and balance, Chairman and CEO, Board membership Board performance and access to information),
- Remuneration matters (including procedures to develop remuneration policies, level and mix of remuneration and disclosure of remuneration),
- Accountability and audit (including accountability, risk management and internal controls, audit committee and internal audit),
- Communication with shareholders (including investor relations and shareholder communication and conduct of shareholder meetings)
- Dealings in the company's securities
- Review of system of internal controls

The following is an extract from the report:

'In the light of continuing uncertainties in the global economies and increasingly challenging competitive business environment, the Board of Directors (the "Board") and Management of China Aviation Oil (Singapore) Corporation Ltd ("CAO" or the "Company") remain committed to achieving the highest standards of corporate governance and in keeping with the Company's corporate philosophy of transparency and integrity. We strive to surpass the minimum requirements of openness. Integrity and accountability prescribed by the Singapore Exchange Securities Trading Limited (the "SGX-ST") and the recommendations of the Code of Corporate Governance (the "2012 Code"). Good corporate governance has become a fundamental part of our corporate culture and business practices of the CAO Group (the "CAO Group") and in ensuring the continued strong performance of our businesses and maintaining investor confidence which underpin the sustainable, long-term growth of our businesses and shareholder value.'

4.8 Integrated reporting

4.8.1 The Integrated Report

The Integrated Report is a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term.

Unlike a traditional financial report that is designed for compliance purposes, an Integrated Report may be prepared in response to existing compliance requirements, and may be either a standalone report or be included as a distinguishable, prominent and accessible part of another report or communication.

There are a few differences between traditional annual reports and the Integrated Report:

<table>
<thead>
<tr>
<th>Feature</th>
<th>Traditional annual report</th>
<th>Integrated Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target audience</td>
<td>Shareholders</td>
<td>Stakeholders</td>
</tr>
<tr>
<td>Thinking and preparation process</td>
<td>Isolated, departments in silos</td>
<td>Integrated, require coordination among departments</td>
</tr>
<tr>
<td>Focus</td>
<td>Financial</td>
<td>Financial and beyond (i.e. environment, social, and governance)</td>
</tr>
<tr>
<td>Time frame</td>
<td>Past; shorter period</td>
<td>Past and future; short, medium and long period</td>
</tr>
<tr>
<td>Framework</td>
<td>Rule-based</td>
<td>Principle-based</td>
</tr>
<tr>
<td>Function serves to the firm</td>
<td>Information function only</td>
<td>Information and internal transformation function</td>
</tr>
<tr>
<td>Compliance</td>
<td>Mandatory</td>
<td>Voluntary</td>
</tr>
</tbody>
</table>

**Genesis of Integrated Reporting**

Since the global financial crisis of 2008, organisations and their operations have been under greater regulatory and investor scrutiny over financial reporting. Coupled with cases of corporate governance failures, growing economic disparities, and the threat of climate change, the call for stakeholder-oriented and more transparent corporate reporting from civil society bodies, regulators and the general public has grown louder. This is in addition to opinions that annual financial reports do not contain sufficient information on the organisation's social, environmental and governance aspects, contain too much specialised language that is impenetrable to most investors, and are simply too lengthy.

As a response to this increased demand, the International Integrated Reporting Council (IIRC) was launched in 2010. The IIRC is a global coalition of regulators, investors, companies, standard setters, accounting professionals and non-governmental organisations. The aim of IIRC is 'to establish integrated reporting and thinking within mainstream business practice as the norm in the public and private sectors.' It is the IIRC's vision to 'align capital allocation and corporate behaviour to wider goals of financial stability and sustainable development through the cycle of integrated reporting and thinking'.

(https://integratedreporting.org/the-iirc-2/ (accessed 8 August 2018))

4.8.2 The <IR> Framework

The International Integrated Reporting Council released the <IR> Framework in December 2013, after extensive consultations with organisations around the world. The <IR> Framework provides guidance on the principles and contents that should be incorporated in integrated reporting. There are three main aspects of an Integrated Report: Capitals, Guiding Principles, and Content Elements. Capitals refer to the types of capital as inputs to enter a business model that a firm uses to create value. Guiding Principles
are guidelines set out for the preparation and presentation of an integrated report. Content Elements are information required to be included in an integrated report.

<table>
<thead>
<tr>
<th>Capitals</th>
<th>Guiding Principle</th>
<th>Content Elements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial</td>
<td>Strategic focus and future orientation</td>
<td>Organisational overview and external environment</td>
</tr>
<tr>
<td>Manufactured</td>
<td>Connectivity of information</td>
<td>Governance</td>
</tr>
<tr>
<td>Intellectual</td>
<td>Stakeholder relationships</td>
<td>Business model</td>
</tr>
<tr>
<td>Human</td>
<td>Materiality</td>
<td>Risks and opportunities</td>
</tr>
<tr>
<td>Social and relationship</td>
<td>Conciseness</td>
<td>Strategy and resource allocation</td>
</tr>
<tr>
<td>Natural</td>
<td>Reliability and completeness</td>
<td>Performance</td>
</tr>
<tr>
<td></td>
<td>Consistency and comparability</td>
<td>Outlook</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Basis of presentation</td>
</tr>
</tbody>
</table>

The <IR> Framework is principle-based. The <IR> Framework allows flexibility for organisations to adjust the categorisation of the capitals. No matter how these are arranged, the capitals identified in the <IR> Framework are only intended to be a guideline. Similarly, the Guiding Principles are not intended to be a template for each Content Element. Rather, the Guiding Principles serve to inform the content of the Integrated Report and how information is presented. Preparers should exercise judgment when applying the Guiding Principles to the Content Elements, particularly if it appears that there may be conflicts between them (e.g., being concise versus being complete).

The relationship among the Capitals, Guiding Principles, and Content Elements can be summarised in this diagram:

4.8.3 Benefits of <IR>

The adoption and implementation of <IR> benefit both stakeholders and organisations:

<table>
<thead>
<tr>
<th>Benefits for stakeholders</th>
<th>Benefits for organisations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate information is easily comprehensible</td>
<td>Improve internal decision making</td>
</tr>
<tr>
<td>Information is more relevant, compiled in a holistic manner and covers financial and non-financial aspects (e.g., environmental, social, and governance)</td>
<td>Increase stakeholder engagement and enhance stakeholder communication</td>
</tr>
<tr>
<td>Able to make more effective capital allocation decisions and facilitate decision making</td>
<td>Boost stakeholders’ confidence and attract long-term investors, resulting in positive capital market consequences (e.g., lower cost of capital, greater institutional ownership, and better terms with suppliers and clients)</td>
</tr>
<tr>
<td>Increase engagement of various types of stakeholders</td>
<td>Signal corporate commitment to stakeholders</td>
</tr>
</tbody>
</table>
4.8.4 Adoption of <IR>

While the <IR> initiative is intuitively appealing, it is more of a voluntary rather than mandatory exercise by firms. South Africa was the first country to adopt <IR> on a mandatory basis. In 2010, the Johannesburg Stock Exchange in its listing rules incorporated the adoption of the King Code of Governance Principles for South Africa 2009 (King III). As the issuance of an Integrated Report is one of the requirements in the King III code, listed companies in South Africa have to comply by issuing an Integrated Report for financial years that start on or after 1 March 2010, or explain why they have not done so. Studies in South Africa suggest that early adoptees gained a number of benefits from <IR> including enhanced reputation, more effective decision-making and breaking down of internal silos.

Brazil also requires mandatory integrated reporting, and there is evidence of momentum towards <IR> in several countries including Australia, Spain, Singapore, Japan, China and the USA. In February 2017, the Securities and Exchange Board of India (SEBI) asked the top 500 listed companies to adopt integrated reporting (on a voluntary basis) from the following financial year; in the EU, the non-financial reporting directive was established in 2016 and identified as a stepping stone to integrated reporting. In the UK 20% of FTSE 100 companies either refer to or are influenced by the <IR> Framework.

4.8.5 Singapore and its <IR> initiative

Currently, several government and professional bodies have expressed their support for <IR> initiatives and taken actions to raise the awareness of the benefits of <IR> and promote <IR> adoption in Singapore. It is believed that Singapore can benefit from the adoption of <IR> for several reasons.

First, the adoption of <IR> increases information dissemination and transparency and thus improves the efficiency of capital markets in Singapore. Investor sophistication is considered low due to the high percentage of retail investors in the capital markets. Retail investors tend to make investing decisions based on hearsay and perceived impressions of the firm rather than rely on corporate information sources due to their lack of relevant accounting or financial knowledge. <IR> improves the traditional annual report in terms of its technical complexity and readability, which may prompt retail investors to use integrated reports to make investing decisions. <IR> also requires disclosures of relevant information of the firm beyond its financial aspect and requires disclosures on how non-financial information could affect value creation. These changes in investor sophistication and information transparency will enhance the efficiency of the stock market.

Second, firms benefit from adopting <IR> through the integrated reporting process and increased stakeholder engagement, which lead to better internal decision making and more favourable capital consequences. The preparation of <IR> promotes integrated thinking and enhances coordination across departments in the firm. This internal transformation function of <IR> increases the firm’s competitive advantage and productivity. Additionally, the adoption of <IR> sends a signal to stakeholders about the firm’s commitment to the protection of stakeholders’ interests and the implementation of <IR> increases stakeholder engagement. These will increase the stakeholders’ confidence in the firm and allow the firm to gain a better position in attracting long-term investors and negotiating better terms with their stakeholders such as suppliers and clients.

Third, with the prevalent adoption of <IR>, more business opportunities emerge for service providers in Singapore. As <IR> is still in its infant stage for developing technical standards, assurance, and other services, service providers in Singapore have better competitive advantages than their competitors from other countries in <IR> technical capability. This will allow them to penetrate other markets when <IR> becomes a standard of future corporate reporting.

Taken together, the adoption and implementation of <IR> increase the capital market efficiency, firms’ competitive advantage and productivity, and more business opportunities in Singapore. These benefits will further cement Singapore’s position as one of the world’s financial hubs and attract more foreign capitals.
SECTION SUMMARY

As the ownership and management of many companies are separate, good communication between a company and its shareholders is crucial. This is often managed by an Investor Relations function. Forms of communication include general meetings and non-financial reports, often published on the company website. The purpose of an AGM is to allow directors to explain how they have managed an organisation, for shareholders to ask questions, for the accounts to be approved and a dividend to be agreed. The purpose of an EGM is to deal with issues which are urgent and cannot wait until the next AGM. Sustainability reporting involves reporting on social and environmental matters in conjunction with their economic effect. The SGX issued a new Sustainability Reporting Guide in 2016 which requires a 'comply or explain' approach from listed companies. Management commentary is a narrative report which sets financial statements in context. It should include discussion of the past and the future. Corporate governance is the way in which companies are managed and controlled by directors on behalf of the shareholders. Corporate governance reports inform stakeholders of the corporate governance processes within a company.

The IIRC <IR> Framework provides guidance on the principles and contents that should be incorporated into an Integrated Report.
Chapter Roundup

Corporate reporting

- Investors
- Employees
- Lenders
- Trade contracts

To stakeholders

- Government
- General public
- Analyst
- Rating agencies

Financial reporting

- Communication with shareholders
  - Increasing via electronic means

Other forms of reporting

- Sustainability
  - GRI standards
  - SGX Sustainability Reporting Guide

- Management commentary
  - FRS Practice Statement 1
  - OFR Guide in SGX LM

- Corporate governance
  - SGX Listing rules
  - Companies Act
  - Code of Corporate Governance
  - Risk Governance
  - Guidance for Listed Entities

Integrated reporting

The <IR> Framework
Quick Quiz

1. What is management commentary?
2. Why do employees require information about a company?
3. Why does the government require information about a company?
4. What are general purpose financial reports?
5. Why is communication with shareholders important?
6. What is the purpose of an EGM?
7. What guidance is available on sustainability reporting?
8. Where can guidance be found on the contents and form of management commentary?
9. What are the key rules, regulations and guidance for corporate governance of listed companies in Singapore?
10. What is the purpose of the Code of Corporate Governance?
### Answers to Quick Quiz

1. It is contextual and non-financial information that is reported alongside financial information in order to provide a more meaningful understanding of a company's business.

2. Employees wish to assess:
   - (a) Job security
   - (b) The prospects of a pay rise
   - (c) The value of outstanding share options

3. The government may be a customer of a company and is therefore concerned with continued supply. It will also be concerned with compliance and tax issues.

4. General purpose financial reports are those financial reports which are intended to serve the needs of many user groups.

5. Shareholders own a company and entrust directors to run it on their behalf. The directors must communicate with shareholders in order that shareholders can assess whether their investment is being managed well.

6. An EGM is held when an urgent issue must be decided by shareholders in between AGMs.

7. The GRI standards and SGX Sustainability Reporting Guide.

8. The ASC’s FRS Practice Statement on Management Commentary and the OFR Guide in SGX LM Practice Note.

9. They are the Listing Rules, Companies Act, Code of Corporate Governance, Risk Governance Guidance for Listed Boards and Guidebook for Audit Committees in Singapore.

10. The Code of Corporate Governance is a principles-based code that aims to improve transparency, independence and decision-making at the board level among executive and non-executive directors in the best interest of shareholders.

### Answer to Question

#### 1.1 Management commentary

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Entity</strong></td>
<td><strong>Entity</strong></td>
</tr>
<tr>
<td>Promotes the entity, and attracts investors, lenders, customers and suppliers</td>
<td>Costs may outweigh benefits</td>
</tr>
<tr>
<td>Communicates management plans and outlook</td>
<td>Risk that investors may ignore the financial statements</td>
</tr>
<tr>
<td><strong>Users</strong></td>
<td><strong>Users</strong></td>
</tr>
<tr>
<td>Financial statements not enough to make decisions (financial information only)</td>
<td>Subjective</td>
</tr>
<tr>
<td>Financial statements backward looking (need forward looking information)</td>
<td>Not normally audited</td>
</tr>
<tr>
<td>Highlights risks</td>
<td></td>
</tr>
<tr>
<td>Useful for comparability to other entities</td>
<td></td>
</tr>
</tbody>
</table>
There is an extensive regulatory framework which governs corporate reporting. In this chapter we consider the different sources of regulation which apply in Singapore. We also consider the development of international accounting standards and their influence on Singapore FRS as well as the adoption of IFRS-identical FRS in Singapore, SFRS(I).
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Standard Setting Process</strong></td>
<td></td>
</tr>
<tr>
<td>Explain the process adopted by the IASB in issuing new accounting standards or amending existing standards.</td>
<td>2</td>
</tr>
<tr>
<td>Explain the mandate of Singapore's ASC.</td>
<td>2</td>
</tr>
<tr>
<td><strong>Regulatory Requirements</strong></td>
<td></td>
</tr>
<tr>
<td>Explain the additional reporting requirements for entities listed on the Singapore Exchange insofar as these go beyond compliance with SFRS(I).</td>
<td>2</td>
</tr>
<tr>
<td>Recognise and apply the legal requirements of Companies Act Cap 50 relating to the preparation of statutory financial statements of an entity, including the circumstances where an entity is required to prepare and present statutory financial statements.</td>
<td>2</td>
</tr>
<tr>
<td>Explain the filing requirements for all entities in Singapore other than the requirements to file tax returns.</td>
<td>2</td>
</tr>
<tr>
<td><strong>The International Context</strong></td>
<td></td>
</tr>
<tr>
<td>Understand the issues relating to the convergence/non-convergence of accounting standards.</td>
<td>2</td>
</tr>
<tr>
<td>Appreciate the key differences between IFRS and domestic accounting standards in Asia.</td>
<td>1</td>
</tr>
<tr>
<td><strong>Emerging Trends</strong></td>
<td></td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments</td>
<td>1</td>
</tr>
</tbody>
</table>

**ESSENTIAL READING**

Companies Act, SGX Rulebooks, SFRS(I) 1 First-time adoption of SFRS(I)

1 Sources of regulation

**SECTION INTRODUCTION**

There are a number of sources of regulation relevant to corporate reporting.

Corporate reporting is normally governed by a number of different sources. In individual countries this is likely to be a combination of:

- National company law
- National accounting standards
- Local stock exchange requirements
Although these are the core sources of regulation in an individual country, the effects of other non-mandatory sources in a particular country may also be relevant, for example:

- International Financial Reporting Standards
- Statutory requirements in other countries
- Long-standing accounting practices in areas not subject to a standard

In many countries, the USA in particular, all the rules from whatever source, which govern accounting are collectively referred to as GAAP (Generally Accepted Accounting Practice). Such a regulatory framework is supplemented by a conceptual framework. This is discussed in more detail in the next chapter.

1.1 Singapore accounting regulatory framework

In Singapore, the following sources regulate the accounting framework:

(a) The Accounting and Corporate Regulatory Authority (ACRA) administers the *Companies Act* (Cap 50), which prescribes the rules relating to the preparation of the statutory financial statements of a corporate entity and includes the circumstances where a corporate entity is required to prepare and present statutory financial statements. In addition to the *Companies Act* (Cap 50), ACRA also administers the *Business Names Registration Act* (2014), the *Limited Liability Partnership Act* (Cap 136A) and the *Limited Partnerships Act* 2008 (Act 37 of 2008), statutes which prescribe the reporting requirements for the respective entity types.

(b) The Accounting Standards Council (ASC), which is responsible for issuing Singapore Financial Reporting Standards (FRS) and Interpretations (INT FRS), as well as IFRS-identical financial reporting standards (SFRS(I)) together with related Interpretations (SFRS(I) INTs). *Application Guidance* is usually found contained within the Standard document and the paragraph numbers are denoted by AG. *Illustrative Examples* (IE) and *Implementation Guidance* (IG) are usually found in a separate document on the ASC website.

The ASC is responsible only for the formulation and promulgation of accounting standards. The monitoring and enforcement of compliance with accounting standards is controlled by the respective regulators, viz. ACRA for companies, Commissioner of Charities for charities, Registrar of Co-operative societies for co-operative societies and Registrar of Societies for societies. Section 4 of this chapter deals with the way in which standards are formulated and issued.

(c) The Singapore Exchange (SGX) prescribes reporting requirements in its Rulebooks that are in addition to compliance with SFRS(I).

(d) There are additional mandatory reporting requirements for specific industries (for instance, casinos and financial institutions).

Within this chapter we clarify the requirements and status of these sources of Singapore-specific regulation, and also consider convergence with international accounting standards (IFRS) and the similarities between these and certain Asian accounting standards. This chapter only deals with the regulatory framework as it affects companies. The regulatory frameworks applicable to government and non-government entities are covered in Chapter 4.

**SECTION SUMMARY**

The mandatory sources regulating the accounting framework in Singapore include the *Companies Act*, Singapore FRS, SFRS(I) and SGX Rulebooks. There are additional mandatory reporting requirements for specific industries.
2 Companies legislation

SECTION INTRODUCTION
There are legal requirements for entities in Singapore to prepare and present statutory financial statements. In addition, there are filing requirements for entities prescribed by regulations.

2.1 Legislation on preparation of financial statements
In Singapore, all companies must comply with the provisions of the Companies Act, Chapter 50 (the Act). The Act requires companies to prepare financial statements for each financial year which give a true and fair view in accordance with the provisions stated in the Act and accounting standards as prescribed by the ASC (s 197).

2.1.1 Requirements of the Companies Act
Part VI Division 1 of the Act which deals with accounts and audits states the key requirements in relation to the preparation and presentation of financial statements.

In particular, Section 199(1) of the Act deals with accounts and audits and states that every company and the directors and managers shall ensure that such accounting and other records are kept that will sufficiently explain the transactions and financial position of the company and enable true and fair profit and loss accounts and balance sheets to be prepared.

Section 201 of the Act requires the directors of companies to present true and fair balance sheet and profit and loss account that complies with the accounting standards. Where compliance with accounting standards would not lead to a true and fair view, the Act requires those standards to be departed from to the extent necessary to give a true and fair view. In such cases, the Act requires disclosure of the particulars of the departure, the reason for it, the financial effect and additional information and explanations to be provided to give a true and fair view.

The Act allows companies to send summary financial statements provided conditions specified are complied with. In addition, the summary financial statement has to state it is only a summary of information in the company's annual accounts and the directors' report (s14B).

The Act also prescribes the filing requirements of annual returns with ACRA and the timelines.

2.1.2 Filing requirements of the Companies Act
Section 197 of the Act requires companies to lodge an annual return with the Registrar within one month of the Annual General Meeting (AGM).

For a public company listed or quoted on a securities exchange in Singapore, accounts presented at the AGM shall be made up to a date not more than four months before the AGM. In the case of any other company, the accounts presented shall be made up to a date not more than six months before the AGM.

A company can apply for an extension of time to hold its AGM. Upon approval of the application, the company must file its annual return within one month of the new AGM date. A private company is exempted from holding an AGM if:

(a) It sends its financial statements to members within five months of the year end; or
(b) All shareholders agree that an AGM is not required.

A penalty will be imposed for late lodgement as prescribed in the Act if a company fails to hold its AGM (if required) or file its annual return. In addition, a summons may be issued against a company director for not holding the company's AGM and filing its annual return as stipulated under the law. Changes to the Companies Act made in 2015 enhanced the Registrar's powers to punish non-compliant companies in an effort to promote greater compliance. As a result of the changes, the Registrar has the power to
debar any director of company secretary who has failed to lodge documents within three months of the deadline. Once debarred, a director or company secretary may not accept any new appointment, although may continue with existing appointments. The debarment will be lifted if the defaults are rectified.

Parliament passed a Companies (Amendment) Bill in 2014 with more than 200 changes being made to the Companies Act as a result. Further amendments were made in 2017. More information on both sets of amendments is available on the ACRA website.

WEBSITE
https://www.acra.gov.sg/legislation/singapore

SECTION SUMMARY
Companies are required by the Companies Act to prepare and publish financial statements for each financial year which give a true and fair view and are prepared in accordance with the accounting standards.

The Act also prescribes that a company must lodge its annual return with the Registrar and penalties are imposed if a company fails to file its annual return within the prescribed period.

3 SGX listing requirements

SECTION INTRODUCTION
There are additional reporting requirements for entities listed on the Singapore Exchange.

3.1 Reporting requirements for listed companies
The following section summarises some of the additional disclosure requirements for listed companies in Singapore as prescribed by the Singapore Exchange Securities Trading Rulebooks (SGX Rulebooks). In addition to the Rulebooks, SGX also issues Directives, Practice Notes and Circulars from time to time in relation to reporting requirements. Directives are binding notices directing companies to take corrective or other actions in the interests of a fair and orderly market or in light of investor protection concerns. Practice Notes are non-binding guidelines that seek to explain the application and interpretation of a Rule. Circulars are binding notices issued by SGX regarding regulatory and non-regulatory matters pertaining to the Market.

You should review the SGX Rulebooks.
3.1.1 Additional requirements of Rulebooks

In addition to the preparation and presentation of statutory annual reports, a listed company is also required to announce the financial statements for each of the first three quarters of its financial year immediately after the figures are available but in any event not later than 45 days after the quarter end, if:

(a) Its market capitalisation exceeded S$75 million as at 31 March 2003;
(b) It was listed after 31 March 2003 and its market capitalisation exceeded S$75 million at the time of listing (based on the initial public offering issue price); or
(c) Its market capitalisation is S$75 million or higher on the last trading day of each calendar year, commencing from 31 December 2006.

Announcement of full year financial statements must be made not later than 60 days after year-end.

For disclosures in the annual report, the Listing Manual requires the disclosure of directors' remuneration as recommended in the Code of Corporate Governance. Under the Code, the company has to fully disclose the remuneration of each individual director and the CEO on a named basis and disclose in aggregate the total remuneration paid to the top five key management personnel who are not directors or the CEO. It also has to ensure that stakeholders can understand the alignment in the level and structure of remuneration to the company's long term objectives, strategy and performance.

There are also additional auditors' fees disclosures broken down into audit and non-audit services, as well as disclosure of fees paid that were not included in the company's profit from operations. The annual report shall also include a confirmation by the Audit Committee that it has undertaken a review of all non-audit services provided by the auditors and they would not, in the Audit Committee's opinion, affect the independence of the auditors. The company shall also undertake a review to determine whether the independence of the auditor has been compromised if the fees paid to the auditor for non-audit services in any financial year of the company exceed 50% of the total amount of fees paid to the auditor in that financial year. The outcome of the review can be communicated through the Directors' Report or the Corporate Governance Report.

The Board of the listed company, with the concurrence of the Audit Committee, is also required to provide an opinion on the adequacy of the company's internal controls, addressing financial, operational and compliance risks.

Shareholders' information disclosed in the annual report is also required to be made up to a date not earlier than one month from the date of notice of the annual general meeting or summary financial statements, whichever is earlier.

Disclosure of material contracts must also be made in the company's annual report if it involves the interests of the chief executive officer, each director or controlling shareholder, either still subsisting at the end of the financial year or if not then subsisting, entered into since the end of the previous financial year.

3.1.2 Current developments

Although quarterly reporting is currently a requirement for listed companies above the size thresholds in Singapore, in January 2018 the SGX sought feedback on whether to retain mandatory quarterly reporting. It suggested that quarterly reporting could be removed altogether or the threshold for quarterly reporting could be increased to a market capitalisation of S$150 million. This follows moves in other countries (in particular those in the EU) to remove the requirement to file quarterly reports and is a response to ongoing criticism that quarterly reporting encourages management to take a short-term view of results.
SECTION SUMMARY
There are additional reporting and disclosure requirements stipulated in SGX Rulebooks. They include additional quarterly reporting requirements not later than 45 days after each quarter end.
Additional requirements in the annual report include directors' remuneration disclosures as recommended in the Code of Corporate Governance, additional auditors' fees disclosures, Audit Committee's opinion on the independence of auditors where auditors provided non-audit services and the need for Board to opine on the adequacy of the company's internal controls.

4 Accounting standards

SECTION INTRODUCTION
International accounting standards are set by the IASB and other countries can adopt and/or adapt these to their specific needs. Singapore has chosen to adapt IFRSs to develop Singapore FRSs, and more recently to adopt IFRSs as SFRS(I)s for use by listed companies.

4.1 Accountancy bodies
Accounting standards throughout the world are set by national and international accountancy bodies. In this section we concentrate on the International Accounting Standards Board (IASB) and Singapore Accounting Standards Council (ASC), considering their respective remits and how they operate to develop new and revised standards.

WEBSITE
www.asc.gov.sg and www.ifrs.org

4.1.1 International Accounting Standards Board
International Financial Reporting Standards (IFRSs) are produced by the International Accounting Standards Board (IASB). The IASB develops IFRSs through an international process that involves the accountancy profession worldwide, the preparers and users of financial statements, and national standard-setting bodies. Prior to 2003 standards were issued as International Accounting Standards (IASs). In 2003 IFRS 1 was issued and all new standards are now designated as International Financial Reporting Standards (IFRSs). Where used, the abbreviation IFRS includes both IFRSs and IASs.
The IASB is overseen by an independent body, the IFRS Foundation, and is supported by two further bodies: the IFRS Advisory Council and the IFRS Interpretations Committee:
(a) The IFRS Advisory Council is made up of about 50 members drawn from organisations all over the world including national standard setters, accountancy firms and the World Bank. It meets with the IASB about three times each year and puts forward the views of its members on current standard-setting projects.
(b) The IFRS Interpretations Committee is currently made up of 14 members and issues guidance where unsatisfactory or conflicting interpretations of accounting standards have developed. It works closely with national committees in order to reach consensus on the appropriate accounting treatment.
The objectives of the IFRS Foundation, the IASB and the other bodies are:

(a) To develop, in the public interest, a single set of high quality, understandable, enforceable and **globally accepted financial reporting standards** based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information to make economic decisions

(b) To promote the use and **rigorous application** of those standards

(c) To take account of the needs of a range of sizes and types of entities in diverse economic settings

(d) To **promote** and **facilitate adoption** of International Financial Reporting Standards

### 4.1.2 Singapore ASC

The Singapore ASC was established in November 2007 to replace its predecessor, the Council on Corporate Disclosure and Governance (CCDG). All standards, interpretations and other directives issued by the CCDG were adopted by the ASC on this date.

The members of the ASC are appointed by the Minister for Finance and they include representatives from stakeholder groups such as the accounting profession, users and preparers of financial information, academia and the Government.

The mandate of the ASC is to develop, review, amend and approve accounting standards for corporate entities, charities, co-operative societies and societies, taking into account:

- The information needs of the stakeholders of the entities
- Facilitation of comparability, disclosure and transparency
- Compatibility with relevant international standards
- Singapore’s reputation as a trusted international business and financial hub

The Council has no responsibility for monitoring and enforcing compliance with accounting standards; the Accounting and Corporate Regulatory Authority (ACRA) takes on this role for companies whilst other bodies monitor charities and societies.

The accounting standards issued by ASC are SFRS(I) and Singapore FRS.

SFRS(I) are IFRS-identical and can be applied to accounting periods starting on or after 1 January 2018. SFRS(I) must be applied by Singapore listed companies and may be applied on a voluntary basis by other companies. Where other companies do not choose to apply SFRS(I) they must apply FRS.

FRS are based on IFRS, but are not necessarily identical. The ASC tracks closely the introduction of new IFRS for possible application in Singapore as an FRS, but it also takes into account the local economic and business circumstances and context as well as the entity to which the accounting standards would apply.

### 4.2 IFRS due process

IFRS are developed through an international consultation process which involves interested individuals and organisations from around the world. They are subsequently adopted as SFRS(I) in Singapore.

Due process comprises six stages:

1. Setting the agenda
2. Planning the project
3. Developing and publishing the discussion paper, including public consultation
4. Developing and publishing the exposure draft, including public consultation
5. Developing and publishing the standard
6. Procedures after the standard is issued
The process resulting in the development of an FRS is as follows:

Flowchart on Prescribing Accounting Standards

1. IASB issues ED
2. Feedback/Exposure period
3. End of consultation
4. IASB reviews comments received and deliberates on final IFRS
5. IASB issues final IFRS
6. ASC to tap on ISCA for the consultation process
7. ASC issues ED at website
8. Feedback from stakeholders to ASC
9. ISCA reviews comments received and drafts reply to IASB for ASC’s consideration
10. ASC to seek feedback from its four committees on the draft reply before submitting to IASB
11. ASC approves final reply and submits to the IASB
12. ASC and ISCA monitor IASB’s developments
13. ISCA reviews new IFRS, including differences from the preceding ED, and makes recommendations to the respective ASC committees
14. Respective ASC committees to consider whether to adopt the IFRS, in full or with modifications, and to recommend accordingly to ASC
15. ASC, based on recommendations from the Committees and advice from technical experts, to decide whether to prescribe the new IFRS as accounting standards in Singapore
16. Publication of the accounting standards on website
4.3 SFRS(I), IAS/IFRS and FRS in issue

A full list of SFRS(I) currently in issue is given below. The equivalent IFRS and FRS are also listed with their issue dates. Some of these standards will seem familiar from your previous studies.

The Financial Reporting syllabus is based on SFRS(I) and the SFRS for Small Entities.

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* SFRS(I) 1-17 Leases is withdrawn for accounting periods beginning on or after 1 January 2019; it is replaced by SFRS(I) 16 Leases.

In addition the IFRS for Small and Medium Sized-Entities was issued in June 2009 and the SFRS for Small Entities in January 2011. There is no equivalent SFRS(I).

Improvements and amendments have been made to a number of standards as a result of limited scope projects and the Annual Improvements Cycles (see Section 4.6.3 below).

#### 4.3.1 Status of IFRS

IFRS are not part of international law and therefore their use is not mandatory in a general sense. Their use in particular countries depends on their adoption by local authorities, which we discuss later in the chapter.

#### 4.4 SFRS(I) and FRS

As we have already mentioned, the ASC has adopted IFRS to be SFRS(I) and adapts IFRS issued by the IASB to become FRS.

- Where SFRS(I) correspond to an IAS they are denoted by 1-X where X is the number as that used for the IAS; where SFRS(I) correspond to an IFRS they are denoted by the same number as that used for the IFRS.
- Where FRS correspond to an IAS, they are denoted by the same number as that used for the IAS; where they correspond to an IFRS the number increases by 100, such that IFRS 2 becomes FRS 102.
The IFRS Foundation issues jurisdiction profiles for a number of countries; the following is a link to the Singapore profile.

4.4.1 SFRS(I)
SFRS(I) is the new Singapore financial reporting framework, applicable from 1 January 2018. It comprises Standards and Interpretations that are equivalent to the following pronouncements issued by the IASB:

- International Financial Reporting Standards (IFRS)
- International Accounting Standards (IAS)
- IFRIC Interpretations
- SIC Interpretations.

Any entity that complies with SFRS(I) will simultaneously comply with IFRS.

The differences between Singapore FRS and IFRS (and therefore SFRS(I)) are minimal, and are detailed above in Section 4.4.1.

Those entities that are required to, or choose to, apply SFRS(I) from 1 January 2018 will be required to apply SFRS(I) 1 First Time Adoption of SFRS(I) on transition to the new reporting framework. This standard is explained in more detail in section 5 of this chapter.

4.4.2 Status of accounting standards in Singapore
Accounting standards as prescribed by the ASC are embodied in the Companies Act and accordingly, companies incorporated under the Companies Act are required to comply with FRS or SFRS(I) in preparing their financial statements. Any director who fails to comply with accounting standards is guilty of an offence and is liable on conviction to a fine or imprisonment or both.

Deviation from the requirements of accounting standards may be allowed in the case of a 'true and fair override', however this is an extremely rare occurrence.

4.4.3 Interpretations
The ASC also issues Interpretations of Financial Reporting Standards (SFRS(I) INT and INT FRS). In its Preface to Interpretations of Financial Reporting Standards the ASC states that the objective of interpretations is 'to enhance the rigorous application and comparability of financial statements' that are prepared using FRS and SFRS(I) by interpreting 'potentially contentious issues' (paragraph 1). SFRS(I) INT which are relevant to your syllabus are covered in the chapter to which their subject matter relates.

4.5 IFRS convergence
As we have seen, the convergence of accounting standards refers to the goal of establishing a single set of accounting standards (IFRS) that will be used internationally. We have already seen that SFRS(I) are identical to IFRS and FRS are largely converged with IFRS.

Convergence throughout the world has been taking place at a relatively slow rate for several decades, however it is now the case that 'all major economies' are planning to either adopt IFRS or converge towards it 'in the near future'. For example, Canada required all listed companies to use IFRS from 1 January 2012 and Saudi Arabia signed a licence with the IFRS Foundation to publish IFRS in Arabic in 2016, which paved the way for adoption of IFRS by all publicly accountable entities including listed companies by 2018. The method of convergence varies from country to country: in some countries IFRS are mandatory for some or all companies, in other countries IFRS may be adopted on a voluntary basis, whereas in certain countries the use of IFRS is prohibited, however local standards are essentially converged. A company can only claim IFRS compliance if it complies with all aspects of IFRS as issued by the IASB.
The following table summarises the use of IFRS and state of convergence in some of the major Asian economies. For further details see [www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx](http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx).

<table>
<thead>
<tr>
<th>Country</th>
<th>Use of IFRS</th>
<th>Chinese Accounting Standards for Business enterprises (ASBEs)</th>
<th>Ministry of Finance plans to eliminate remaining differences over time</th>
<th>China has committed to adopt IFRS for reporting by at least some domestic companies, although there is no timetable for this process</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>Use of IFRS is not permitted.</td>
<td>Chinese Accounting Standards for Business enterprises (ASBEs) are substantially converged with IFRS</td>
<td>The Ministry of Finance plans to eliminate remaining differences over time</td>
<td>China has committed to adopt IFRS for reporting by at least some domestic companies, although there is no timetable for this process</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Certain listed companies may use IFRS.</td>
<td>Hong Kong FRS (HKFRS) are fully converged with IFRS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>All domestic companies whose securities trade in a public market other than the SME exchange are required to use Indian Accounting Standards (Ind AS).</td>
<td>Ind AS are based on and substantially converged with IFRS as issued by the IASB</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>Use of IFRS is not permitted.</td>
<td>Indonesian Financial Accounting Standards (SAK) are not converged, however it is intended that differences will be gradually reduced. Since 2012 the local standards applied in Indonesia are based on IFRS with some modifications. Since 2015, a one year difference with IFRS has been maintained, such that SAK will be converged with IFRSs as they stood on 1 January 2017 as of 1 January 2018 and so on.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>Most listed companies may use IFRS for their consolidated financial statements.</td>
<td>In addition, listed companies may use: Historic Japanese GAAP; Japan's Modified International Standards (JMIS). JMIS are based on IFRS, with modifications and deletions determined by the Accounting Standards Board of Japan; or With permission, US GAAP. As at June 2018, approximately 30% of Japanese listed companies report under or plan to report under IFRS.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>South Korea</td>
<td>All listed and certain unlisted companies must use IFRS. Other unlisted companies may apply IFRS.</td>
<td>IFRS as published by the IASB are translated into Korean word for word and known as K-IFRS.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>Malaysian FRS (MFRS) must be applied by all non-private entities from 1 January 2012.</td>
<td>MFRS are identical to IFRS. The Malaysian equivalent to the IFRS for SMEs is effective from 2016.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Thailand</td>
<td>Use of IFRS is not permitted.</td>
<td>Thailand has adopted all IFRS standards with a one-year delay, with the exception of the financial instruments standards (IAS 32, IAS 39, IFRS 7 and IFRS 9) which will be effective from 2020. As of 1 January 2017, Thai FRS (TFRS) are aligned with IFRS as issued in 2016. It is intended that on an ongoing basis, IFRS will be adopted one year after the IFRS effective date. Thailand is also in the process of adopting the IFRS for SMEs in full.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**Question 2.1**

Suggest reasons why convergence is seen as desirable on a global basis.

---

### 4.6 Current developments in IFRS

IFRS are continually evolving, and the IASB is currently engaged in a number of ongoing active agenda projects in order to improve existing and continue to develop new standards. To view the IASB work plan visit [www.ifrs.org/Current-Projects/IASB-Projects/Pages/IASB-Work-Plan.aspx](http://www.ifrs.org/Current-Projects/IASB-Projects/Pages/IASB-Work-Plan.aspx).

The IASB splits its work plan into standard-setting and related projects, maintenance of IFRS standards, research projects and post-implementation reviews. The technical detail of projects that have resulted in an exposure draft is dealt with in the relevant chapter of this Textbook, however an overview of all projects is given below.

#### 4.6.1 Standard-setting and related projects

The IASB currently has two IFRS projects in progress, being:

- A project to revise and update IFRS Practice Statement *Management Commentary*
- A new standard on rate-regulated activities

An exposure draft on the first project is not expected until 2020 and the second project is outside the scope of your syllabus.

#### 4.6.2 Maintenance of IFRS standards

There are a number of narrow scope amendments projects at various stages of completion. The following are at an early stage and no exposure draft has yet been issued:

- Costs Considered in Assessing whether a Contract is Onerous (Amendments to IAS 37)
- Disclosure Initiative – Accounting Policies
- Disclosure Initiative – Targeted Standards-level Review of Disclosures
- Fees in the ‘10 per cent’ test for Derecognition (Amendments to IFRS 9)
- Lease incentives (Amendment to Illustrative Example 13 accompanying IFRS 16)
- Subsidiary as a First-time Adopter (Amendments to IFRS 1)
- Taxation in Fair Value Measurements (Amendments to IAS 41)

In these cases exposure drafts have been issued, comments received from constituents and final amendments are expected during 2018.

- Definition of a Business (Amendments to IFRS 3)
- Disclosure Initiative – Definition of Material (Amendments to IAS 1 and IAS 8)
- Property, Plant and Equipment: Proceeds before Intended Use (Amendments to IAS 16)

In these cases exposure drafts have been issued, but analysis is ongoing.

- Accounting Policies and Accounting Estimates (Amendments to IAS 8)
- Accounting Policy Changes (Amendments to IAS 8)
- Classification of Liabilities (Amendments to IAS 1)

A number of these projects relate to the Disclosure Initiative. This is a wide-ranging programme that encompasses a number of small projects to amend existing standards in order to improve the usefulness of information provided in financial statements.

#### 4.6.3 Research projects

The IASB’s research programme exists to assess perceived problems or deficiencies in IFRS requirements. These projects undergo extensive academic research with the findings published in a Discussion Paper.
The IASB will then decide whether to add it to their active agenda for further review and development as required.

Current research topics include discount rates, business combinations under common control and primary financial statements.

4.6.4 Annual improvements

Annual improvements are part of the IASB’s narrow scope amendments.

The annual improvements projects form a streamlined process for dealing with a number of minor amendments to standards. Each year the IASB discusses and decides upon proposed amendments to IFRSs as they have arisen throughout the year. In order to be included in the annual improvements process the amendments must clarify existing standards or correct conflicts or oversights, but not propose a new principle or change to an existing principle.

Proposed annual improvements are usually published annually in the second or third quarter within an omnibus exposure draft, and final amendments are issued in the following year. Each annual improvements cycle therefore lasts two years.

There are currently no annual improvements projects underway; the 2015–17 cycle was completed in December 2017.

4.6.5 Post-implementation reviews

The IASB normally conducts a post-implementation review (PIR) of a new standard or major amendment to an existing standard after the standard has been implemented for two years internationally (normally 30–36 months after the effective date).

In undertaking a PIR the Board:

- Considers important or contentious matters in the development of the standard;
- Considers issues that have come to the Board’s attention since the issue of the standard; and
- Identify areas where unexpected costs or implementation problems were encountered.

At the end of a PIR, the IASB publishes a summary of its findings and sets out the steps that it plans to take, which may involve a standard-setting or maintenance project.

A PIR of IFRS 13 *Fair Value Measurement* is currently underway.

**SECTION SUMMARY**

IFRS are developed by the IASB with the support of other organisations of the IFRS Foundation. There is open and transparent due process for the development of a new standard involving six stages. In Singapore the ASC adopts IFRS as SFRS(I) and develops FRS based on IFRS with certain minor technical and effective date differences. The convergence of accounting standards refers to the goal of establishing a single set of accounting standards that will be used internationally. Convergence has taken place at a varied rate within Asia, with some countries’ national standards now fully converged with IFRS. Listed companies in Singapore are required to apply SFRS(I) from 2018. The IASB is continually improving and developing IFRS and has a number of ongoing projects.
5 SFRS(I) 1 First-time Adoption of SFRS(I)

SFRS(I) 1 First-time Adoption of SFRS(I) must be applied by companies that transition from FRS to SFRS(I) in, and after, 2018. The standard sets out the procedures that a reporting entity should follow when adopting SFRS(I) for the first time and provides exemptions from the general requirement to comply with SFRS(I). It ensures that an entity's first SFRS(I) financial statements contain high quality information that:

(a) Is transparent for users and comparable over all periods presented
(b) Provides a suitable starting point for accounting under SFRS(I)
(c) Can be generated at a cost that does not exceed the benefits to users

5.1 Date of transition

An entity's first SFRS(I) financial statements are its first annual financial statements in which it applies SFRS(I) and in which it makes an explicit and unreserved statement of compliance with SFRS(I). The requirement to apply SFRS(I) in those financial statements applies to both current year and comparative amounts equally.

As comparative amounts in the financial statements for the first year of SFRS(I) adoption must be prepared under SFRS(I), the date of transition to SFRS(I) is the start of the comparative period. At this date an SFRS(I) compliant statement of financial position must be prepared as a starting point upon which the comparative and current year financial statements build.

<table>
<thead>
<tr>
<th>Comparative year</th>
<th>1st Year of adoption</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1.17</td>
<td>31.12.17</td>
</tr>
<tr>
<td>31.12.18</td>
<td></td>
</tr>
</tbody>
</table>

Date of transition First SFRS(I) financial statements

The transition to reporting under SFRS(I) constitutes a change in accounting policy, and therefore in line with SFRS(I) 1-1, three statements of financial position should be presented in the first SFRS(I) financial statements:

- At the transition date (start of the comparative period – 1.1.17);
- At the end of the comparative period (31.12.17); and
- At the reporting date (31.12.18).

Two statements of profit or loss and other comprehensive income, two statements of cash flows and two statements of changes in equity are required. As comparative amounts are prepared in line with SFRS(I), amounts in the comparative statements will not correspond to amounts in the financial statements as previously reported.

5.2 Preparation of transition date SFRS(I) statement of financial position

SFRS(I) 1 is mainly concerned with the preparation of the first SFRS(I) statement of financial position as at the transition date. In preparing the transition date statement of financial position, SFRS(I) 1 requires the following general principles to be applied (subject to certain exemptions and exceptions, which are discussed later):

1 Accounting policies that are applied must comply with SFRS(I) in effect at the end of the first SFRS(I) financial statements; the same accounting policies must be applied throughout all periods presented in the first SFRS(I) financial statements.
2 Assets and liabilities whose recognition is required by SFRS(I) should be recognised.
3 Assets and liabilities whose recognition is not permitted by SFRS(I) should not be recognised.
4 Items that have been recognised as one type of asset, liability or equity component under previous GAAP, but are recognised as another type of asset, liability or equity component in accordance with SFRS(I) are reclassified.

5 Assets and liabilities are measured in accordance with SFRS(I).

As the adoption of SFRS(I) is a change in accounting policy, the treatment required by SFRS(I) 1 mirrors that within SFRS(I) 1-8; the principles above effectively prescribe the retrospective application of SFRS(I), and any adjustments resulting from the application of SFRS(I) rather than previous GAAP are recognised directly in equity.

SFRS(I) 1 contains a number of mandatory exceptions to the general principle of retrospective application as well as optional exemptions from the requirements of SFRS(I). There is also a short-term exemption from disclosure requirements of SFRS(I) 9.

5.2.1 Application of SFRS(I) 1 in Singapore

Even though Singapore FRS are essentially converged with SFRS(I), SFRS(I) 1 remains relevant to companies that transition from FRS to SFRS(I), and transition adjustments are likely to arise. This is because the transition provisions of SFRS(I) 1 are different from those within individual standards.

Illustration

Moor Field Limited (MFL) acquired an interest in a joint venture on 1 January 2012 and accounted for it using proportionate consolidation as allowed by FRS 31 Interests in Joint Ventures.

On 1 January 2014, FRS 31 was superseded by FRS 111 and MFL adopted equity accounting as required by FRS 111 Joint Arrangements to account for the interest. In transitioning to the new standard MFL applied the FRS 111 transition guidance for the adoption of equity accounting, using the aggregate carrying amount of assets and liabilities that were previously proportionately consolidated as deemed cost for equity accounting.

On 1 January 2018, MFL transitions to SFRS(I) and is required to apply SFRS(I) 11. Disregarding available exemptions, SFRS(I) 1 requires that MFL applies equity accounting to its interest in a joint venture retrospectively ie as if it had been applied since 1 January 2012.

Therefore the carrying amount of the investment under SFRS(I) 11 (based on original cost on 1 January 2012) differs from that under FRS 111 (based on the aggregate carrying amount of assets and liabilities that were previously proportionately consolidated), and adjustment is required on adoption of IFRS.

5.3 Mandatory exceptions to retrospective application

SFRS(I) 1 provides certain mandatory exceptions to retrospective application of SFRS(I). These exceptions cover areas in which the IASB believe that retrospective application could not be applied with sufficient reliability.

1 Accounting estimates

Accounting estimates that were made under previous GAAP and that are required under SFRS(I) (eg useful lives) are not adjusted other than to reflect differences in accounting policies or unless there is evidence that the estimates were in error.

2 Derecognition of financial assets and liabilities

SFRS(I) 9 derecognition requirements are applied prospectively, meaning that any financial instruments derecognised under previous GAAP remain derecognised, even if SFRS(I) 9 derecognition criteria were not met.

3 Hedge accounting

Hedge accounting is reflected in the transition date statement of financial position only for relationships that qualified for hedge accounting under previous GAAP and qualify for hedge accounting under SFRS(I) 9. If an entity hedged a net position under previous GAAP, it may designate an individual item within that net position as a hedged item on transition to SFRS(I). Transactions entered into before the transition date are not retrospectively designated as hedges.
Classification and measurement of financial assets

The SFRS(I) 9 conditions for the classification of a financial asset as measured at amortised cost or fair value through other comprehensive income are assessed at the date of transition. If it is impracticable to apply the effective interest method retrospectively to those classified as measured at amortised cost, the fair value of the financial instrument at the date of transition forms the new carrying amount. The effective interest method is applied thereafter.

Impairment of financial assets

The SFRS(I) 9 impairment requirements are applied retrospectively; at the date of transition an entity must determine credit risk at the date that a financial instrument was originally recognised and compare that to credit risk at the date of transition (based on SFRS(I) 9 guidance). If determining whether there has been a significant increase in credit risk would require undue cost or effort, a loss allowance equal to lifetime expected credit losses should be recognised at each reporting date, unless the financial instrument is low credit risk at a reporting date.

Embedded derivatives

A first-time adopter should assess whether an embedded derivative must be separated from the host contract and accounted for as a derivative on the basis of conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by SFRS(I) 9.

Exceptions 2–6 all relate to financial instruments; entities that transitioned from FRS to SFRS(I) on 1 January 2018 were also likely to be transitioning from the old financial instruments standard (FRS 39) to the new (SFRS(I) 9, converged with FRS 109). The derecognition model in the old and new standard is the same, however the conditions to hedge account, the classification and measurement of financial instruments rules, the impairment model, and certain aspects of accounting for embedded derivatives are different.

Non-controlling interests

A first-time adopter applies the following requirements of SFRS(I) 1-27 prospectively from the date of transition:

- The requirement that total comprehensive income is attributed to the owners of the parent and the non-controlling interest even if this results in a negative non-controlling interest balance;
- The requirements regarding accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and
- The requirements regarding accounting for a loss of control over a subsidiary, including the requirement to classify the subsidiary as held-for-sale if SFRS(I) 5 criteria are met.

Government loans

At the transition date all government loans received must be classified as a liability or equity in accordance with SFRS(I) 1-32. SFRS(I) 9 and SFRS(I) 1-20 are applied prospectively from the date of transition (unless sufficient information was obtained at the time of initially accounting for the loan to allow retrospective application)

In the case of a government loan at a below-market rate of interest, if previous GAAP did not result in recognition and measurement consistent with SFRS(I), the previous GAAP carrying amount at the date of transition becomes the carrying amount in the transition date statement of financial position.

5.4 Optional exemptions

The optional exemptions available within SFRS(I) 1 permit a first-time adopted to choose to apply certain SFRS(I) accounting policies prospectively from the date of transition, rather than apply them retrospectively. These are available in areas in which the IASB believes that the cost of applying SFRS(I) retrospectively exceeds the benefits.
Where an exemption is taken, the alternative accounting specified in SFRS(I) 1 is applied when preparing the transition date statement of financial position.

### 5.4.1 Business combinations

SFRS(I) 3 may be applied retrospectively and the acquisition method applied to all past business combinations, however this is likely to be onerous and often impracticable.

Where the available exemption is applied:

- The classification of business combinations as an acquisition or uniting of interest under previous GAAP is maintained;
- Assets and liabilities of the acquiree are assessed at the transition date for recognition in consolidated financial statements (by applying the requirements of SFRS(I));
- There is no remeasurement of acquisition date fair values; and
- The carrying amount of goodwill under previous GAAP is not adjusted except where impaired or where adjustment is required to reflect the recognition/non-recognition of intangible assets at the acquisition date.
- Acquirees that were previously not consolidated but that are controlled under SFRS(I) 10 are consolidated from the date of transition based on assets and liabilities measured as if SFRS(I) had always been applied. Goodwill is measured as the difference between the parent's interest in the carrying amount of those assets and liabilities and the cost of the investment in the subsidiary.

An entity can elect to apply the exemption to business combinations before a certain date, for example it may choose to apply the standard retrospectively to business combinations from 1 January 2014 (the date on which FRS 103, converged with SFRS(I) 3, became effective) but apply the exemption to business combinations before this date.

Other SFRS(I) related to group accounting (SFRS(I) 1-28, SFRS(I) 10 and SFRS(I) 11) must be applied retrospectively from the same date as SFRS(I) 3.

### Example

Black Stone Limited (BSL) plans to transition to SFRS(I) on 1 January 20X8. It acquired 80% of Green House Limited (GHL) on 1 June 20X6, calculating goodwill based on cost less share of net assets at $340,000 and recognising the net assets of GHL at that date in accordance with its previous GAAP. One of the liabilities in GHL that was recognised was a restructuring provision of $180,000; assets included intangible assets with a carrying amount of $70,000. Neither the provision nor the intangible assets would have met SFRS(I) 3 criteria to be recognised. At the date of transition, GHL had paid restructuring costs of $100,000 and expected to have to pay a further $80,000 in 20X8; the carrying amount of the intangible assets was reduced to $60,000 due to amortisation.

What adjustments are made to the transition date BSL consolidated statement of financial position assuming that the SFRS(I) 1 available exemption is applied (ignore deferred tax)?

### Solution

BSL should:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restructuring provision</td>
<td>Intangible asset</td>
</tr>
<tr>
<td>Goodwill (80% × 60,000)</td>
<td>Retained earnings</td>
</tr>
<tr>
<td>Non-controlling interest (20% × 60,000)</td>
<td>Non-controlling interest</td>
</tr>
<tr>
<td>$80,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>$48,000</td>
<td>$64,000</td>
</tr>
<tr>
<td>$12,000</td>
<td>$16,000</td>
</tr>
</tbody>
</table>

The carrying amount of goodwill is adjusted only for the intangible asset; not for the provision.
5.4.2 Share-based payment transactions

Two exemptions exist in relation to equity-settled transactions:

1. First-time adopters need not apply SFRS(I) 2 for equity-settled share-based payments granted on or before 7 November 2002; and

2. First-time adopters need not apply SFRS(I) 2 to share-based payments granted after 7 November 2002 that vested before the date of transition to SFRS(I).

An entity must use these exemptions unless it has disclosed publicly the fair value of its equity instruments at the measurement date (normally grant date).

In relation to cash-settled transactions, first-time adopters are not required to apply SFRS(I) 2 to liabilities arising from share-based payment transactions that were settled before the date of transition.

5.4.3 Deemed cost of assets

First-time adopters that apply the deemed cost exemption need not recreate cost information in relation to property, plant and equipment, right-of-use assets, investment property and intangible assets in order to apply SFRS(I) 1-16, SFRS(I) 1-40 and SFRS(I) 1-38 retrospectively. Instead the deemed cost of these assets at the date of transition is:

- Fair value at the date of transition; or
- A revaluation under previous GAAP (if broadly comparable to fair value or cost/depreciated cost under SFRS(I), adjusted for changes in a price index); or
- A deemed cost measurement recognised under previous GAAP based on fair value at the date of a specific event e.g. a privatisation.

Example

Acremead Limited (AL) is preparing to transition to SFRS(I) and has identified a transition date of 1 January 20X7. Its accounting policy under previous GAAP was to not to amortise intangible assets but to revalue them every three years and recognise any gains or losses in equity. AL acquired a licence on 1 January 20X2 for $160,000; the licence expires on 31 December 20X9. On 31 December 20X4 the licence was revalued to $240,000. This valuation was determined to be the same as fair value. The fair value of the licence on 1 January 20X7 was determined to be $350,000. AL elects to apply the cost model for intangible assets under SFRS(I) 1-38.

What journal entries are required on transition to SFRS(I)

(a) If AL does not use the SFRS(I) 1 exemption that is available
(b) If AL uses the exemption and deems cost to be fair value
(c) If AL uses the exemption and deems cost to be revalued amount under previous GAAP?

Solution

Retrospective application of SFRS(I) 1-38 (ie not using available exemptions)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revaluation surplus (240,000 – 160,000)</td>
<td>$80,000 Intangible asset</td>
</tr>
<tr>
<td>$100,000 Retained earnings (160,000 × 5/8years)</td>
<td>$100,000 Intangible asset – amortisation</td>
</tr>
</tbody>
</table>

to reverse revaluation under previous GAAP
to recognise amortisation on a cumulative basis since acquisition
Deemed cost equal to fair value at transition date

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Retained earnings (350,000 – 240,000)</th>
<th>$110,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Intangible asset</td>
<td></td>
</tr>
</tbody>
</table>

Deemed cost equal to previous GAAP revaluation

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Retained earnings (240,000 × 2/5)</th>
<th>$96,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Intangible asset – amortisation</td>
<td></td>
</tr>
</tbody>
</table>

5.4.4 Leases

A first-time adopter may assess whether a contract contains a lease at the date of transition to SFRS(I) rather than apply the SFRS(I) 16 requirement to do so at the inception of the lease.

At the date of transition, rather than applying SFRS(I) 16 retrospectively, an entity may apply the following treatment:

<table>
<thead>
<tr>
<th>Lease liability</th>
<th>Measure at the present value of remaining lease payments at the date of transition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>Choose on a lease-by-lease basis to measure at:</td>
</tr>
<tr>
<td></td>
<td>• An amount equal to the lease liability, adjusted by the amount of prepaid or accrued lease payments recognised immediately before the date of transition, or</td>
</tr>
<tr>
<td></td>
<td>• Its carrying amount as if SFRS(I) 16 had been applied since the commencement of the lease, discounted using the lessee's incremental borrowing rate at the date of transition.</td>
</tr>
</tbody>
</table>

Apply SFRS(I) 1-36 Impairment of Assets at the date of transition.

If the underlying asset is an investment property measured using the SFRS(I) 1-40 fair value model, the right-of-use asset is measured at fair value at transition date.

On transition, SFRS(I) 16 simplified accounting may be applied to any lease ending within 12 months and any lease for a low value asset. This option is available on a lease-by-lease basis.

5.4.5 Translation differences

A first-time adopter need not apply SFRS(I) 1-21 to cumulative translation differences that existed at the date of transition in respect of:

(a) Recognising certain translation differences in other comprehensive income and
(b) Reclassifying cumulative translation differences to profit or loss to form part of the gain or loss on disposal of a foreign operation.

Instead, the cumulative translation differences for all foreign operations at the date of transition are deemed to be zero, SFRS(I) 1-21 requirements are applied prospectively and any gain or loss on subsequent disposal of a foreign operation includes only those translation differences that arose after the date of transition.

5.4.6 Investments in subsidiaries, associates and joint ventures

SFRS(I) 1-27 requires that such an investment is measured in the separate financial statements of the investor either at cost, in accordance with SFRS(I) 9 or using the SFRS(I) 1-28 equity method.

Where a first-time adopter measures investments at cost in its separate financial statements, cost is either that determined in accordance with SFRS(I) 1-27 (ie the standard is applied retrospectively) or deemed cost. Deemed cost is the fair value of the investment at the date of transition or the previous GAAP carrying amount at that date.
5.4.7 Assets and liabilities of subsidiaries, associates and joint ventures (applies only where parent and subsidiary adopt SFRS(I) at different dates)

If a subsidiary becomes a first-time adopter later than its parent, the subsidiary may measure its assets and liabilities either:

- At the carrying amounts required by SFRS(I) 1 based on the subsidiary’s date of transition; or
- At the carrying amounts that would be included in the parent’s consolidated financial statements based on its date of transition to SFRS(I) (with no adjustments for consolidation procedures or the effects of the business combination).

If a parent becomes a first-time adopter later than its subsidiary, in the consolidated financial statements the parent should measure the assets and liabilities of the subsidiary at the same carrying amount as in the financial statements of the subsidiary (subject to consolidation adjustments and the adjusting for the effects of the business combination).

5.4.8 Compound financial instruments

If the liability component is no longer outstanding at the date of transition, the equity balance in relation to a compound financial instrument need not be split into its two parts (being the original equity recognised when split accounting was first applied and the accumulation of interest resulting from the application of the effective interest method to the liability component throughout its life).

5.4.9 Designation of previously recognised financial instruments

SFRS(I) 9 allows, in given circumstances, certain financial instruments to be designated as measured at fair value at initial recognition. An entity may make this designation instead at the transition date in the following circumstances:

- A financial liability may be designated as measured at fair value through profit or loss provided it meets the SFRS(I) 9 criteria at the date of transition.
- A financial asset may be designated as measured at fair value through profit or loss based on facts and circumstances that exist at the transition date.
- An equity instrument may be designated as measured at fair value through other comprehensive income based on facts and circumstances that exist at the transition date.

5.4.10 Fair value measurement of financial instruments at initial recognition

SFRS(I) 9 guidelines regarding the measurement of financial instruments at fair value at initial recognition may be applied prospectively to transactions entered into on or after the date of transition.

5.4.11 Decommissioning liabilities included in the cost of property, plant and equipment

SFRS(I) INT 1 Changes in Decommissioning, Restoration and Similar Liabilities requires specified changes in a decommissioning or restoration provision to be added to or deducted from the carrying amount of the related asset. This affects subsequent depreciation charges on the asset.

In order that an entity does not have to construct a record of historic changes in the carrying amount of the related asset, an exemption from retrospective application of this requirement is available. Where applied, the exemption requires that the first-time adopter:

- Measures the liability at the date of transition in accordance with SFRS(I) 1-37;
- Where the liability is within the scope of SFRS(I) INT 1, estimates the amount that would have been included in the cost of the related asset when the liability first arose (by discounting the liability); and
- Calculates the accumulated depreciation on that amount at the date of transition based on the current estimate of useful life of the asset and a depreciation policy that is in line with SFRS(I).
Example

West Riding Limited (WRL) has identified its date of transition to be 1 January 20X7. On 1 January 20X4, the company acquired an energy plant with a life of 20 years.

At 1 January 20X7 the decommissioning cost in 17 years' time is estimated to be $520,000 and an appropriate risk-adjusted discount rate is 5%.

WRL's previous GAAP did not contain similar requirements to SFRS(I) and it has not recognised a liability in respect of the decommissioning costs.

What adjustment is required in the transition date statement of financial position?

Solution

The decommissioning liability recognised at the transition date is $226,720 ($520,000/1.05^{17})

Discounting this liability back a further three years gives a liability at the acquisition date of the plant of $196,040 ($520,000/1.05^{20})

This is included in the cost of the plant and depreciated over its 20 year life. Therefore accumulated depreciation to the transition date is $29,406.

The following adjustment is therefore required:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>$196,040</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>Decommissioning liability</td>
</tr>
<tr>
<td></td>
<td>$60,086</td>
</tr>
<tr>
<td></td>
<td>$29,406</td>
</tr>
<tr>
<td></td>
<td>$226,720</td>
</tr>
</tbody>
</table>

5.4.12 Assets accounted for in accordance with SFRS(I) INT 12

A first-time adopter may apply the transitional provisions of SFRS(I) INT 12, ie if it is not practicable to apply the Interpretation retrospectively at the start of the earliest period presented, an entity may:

(a) Recognise financial assets and intangible assets that existed at the transition date;

(b) Use previous carrying amounts of those items as carrying amounts at the transition date; and

(c) Test recognised assets for impairment at the transition date (or the start of the first SFRS(I) period if that is impracticable).

5.4.13 Borrowing costs

A first-time adopter may apply SFRS(I) 1-23 from the date of transition or an earlier date. From that date the reporting entity:

(a) Must not restate borrowing costs that were capitalised under previous GAAP and are included in the carrying amount of assets, and

(b) Must account for borrowing costs incurred on or after that date in accordance with SFRS(I) 1-23 (including borrowing costs on assets already under construction).

5.4.14 Extinguishing financial liabilities with equity instruments

A first-time adopter may apply the transitional provisions of SFRS(I) INT 19 ie it may apply a change in accounting policy in accordance with SFRS(I) 1-8 from the transition date.
5.4.15 Joint arrangements

Rather than applying SFRS(I) 11 retrospectively, the transitional arrangements of SFRS(I) 11 may be on first-time adoption of SFRS(I).

5.4.16 Revenue

A first time adopter may apply one or more of the following exemptions:

(a) Completed contracts need not be restated;

(b) For completed contracts with variable consideration, the transaction price at the date the contract was completed may be used rather than estimating variable consideration at earlier dates

(c) For the comparative reporting period, the transaction price allocated to the remaining performance obligations and an explanation of when the entity expected to recognise that as revenue need not be disclosed.

5.4.17 Foreign currency transactions and advance consideration

A first time adopter is not required to apply SFRS(I) INT 22 to items recognised before the date of transition to SFRS(I).

5.5 Short-term exemption

SFRS(I) 1 currently provides a short-term exemption in relation to the requirement to restate comparative information for SFRS(I) 9.

As entities transitioning from FRS to SFRS(I) on 1 January 2018 are likely to also be transitioning from the old financial instruments standard (FRS 39) to the new SFRS(I) 9, converged with FRS 109, this is a relevant short-term exemption.

It allows that where an entity's first SFRS(I) reporting period begins before 1 January 2019 and it applies SFRS(I) 9 as issued in 2014, the comparative information presented in the first SFRS(I) financial statements need not comply with SFRS(I) 7 Financial Instruments: Disclosure or SFRS(I) 9 to the extent that the disclosures required by SFRS(I) 7 relate to items within the scope of SFRS(I) 9.

Instead, an entity applying this exemption should apply the requirements of its previous GAAP in respect of items within the scope of SFRS(I) 9 and disclose this fact. Any adjustments between amounts reported in the comparative statement of financial position and the SFRS(I) statement of financial position at the start of the first SFRS(I) period are treated as arising from a change in accounting policy and SFRS(I) 1-8 should be applied.

5.6 Disclosure

In its first SFRS(I) financial statements a reporting entity must explain how the transition from previous GAAP to SFRS(I) affected its reported financial position, financial performance and cash flows. This is achieved by presenting reconciliations between amounts reported under previous GAAP and amounts reported under SFRS(I):

(a) Equity at the transition date and the end of the latest period presented in the most recent financial statements under previous GAAP.

(b) Total comprehensive income for the latest period in the entity's most recent financial statements.

In addition, if the reporting entity recognised or reversed any impairment losses for the first time in preparing its transition date SFRS(I) statement of financial position, relevant SFRS(I) 1-36 disclosures should be provided.

Additional disclosures are provided in respect of exemptions applied:
<table>
<thead>
<tr>
<th>Exemption</th>
<th>Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Designation of financial assets or liabilities as measured at fair value through profit or loss.</td>
<td>Fair value of the financial instrument at the designation date and classification and carrying amount in previous financial statements.</td>
</tr>
</tbody>
</table>
| Use of fair value as deemed cost (property, plant and equipment, investment property, intangible assets, right-of-use assets) | For each line item in the opening SFRS(I) statement of financial position:  
  - The aggregate of those fair values, and  
  - The aggregate adjustment to carrying amounts under previous GAAP. |
| Use of fair value as deemed cost (investments in subsidiaries, associates and joint ventures) |  
  - The aggregate deemed cost of investments for which deemed cost is their previous carrying amount.  
  - Aggregate deemed cost of investments for which deemed cost is fair value.  
  - Aggregate adjustment to carrying amounts under previous GAAP. |
Chapter Roundup

SFRS(I) 1 *First-time Adoption of SFRS(I)*

**Date of transition**
statement of financial position

**Start of accounting period**
before SFRS(I) applied

**Mandatory exceptions**
- Accounting estimates
- Derecognition of financial instruments
- Hedge accounting
- Classification and measurement of financial assets
- Impairment of financial assets
- Embedded derivatives
- Non-controlling interest
- Government loans

**Optional exemptions**
- Business combinations
- Share-based payments
- Deemed cost of assets
- Leases
- Translation differences
- Investments in subsidiaries, associates and joint ventures
- Assets and liabilities of subsidiaries, associates and joint ventures
- Compound financial instruments
- Designation of financial instruments
- FV of financial instruments at initial recognition
- Decommissioning liabilities
- Assets under SFRS(I) INT 12
- Borrowing costs
- Extinguishing financial liabilities with equity instruments
- Joint arrangements
- Revenue
- Foreign currency transactions and advance consideration

**Disclosures**
- Reconciliation of equity
- Reconciliation of total comprehensive income
- Specific exemption disclosures
Singapore Accounting Regulatory Framework

Companies Act (Cap 50)
- Companies must prepare financial statements
  - True and fair view
  - In accordance with accounting standards

SGX Rulebooks
- Additional reporting and disclosure requirements for listed companies

Accounting Standards Council
- FRS and INT FRS
- SFRS(I)

IASB
- IFRS
  - Development (six stages)
  - Improvements
  - Convergence

Singapore Accounting Regulatory Framework

Accounting Standards Council
- FRS and INT FRS
- SFRS(I)

IASB
- IFRS
  - Development (six stages)
  - Improvements
  - Convergence
Quick Quiz

1. Who/what are the major contributors to the Singapore accounting regulatory framework?
2. Which Singapore legislation requires companies to prepare true and fair financial statements?
3. Which international body issues guidance where unsatisfactory or conflicting interpretations of accounting standards have developed?
4. What are the stages in the development of an IFRS?
5. What is the legal status of accounting standards in Singapore?
6. Identify a set of Asian standards which are fully converged with IFRS.
7. What is the purpose of the IASB’s annual improvements process?
8. An entity’s first SFRS(I) period is the year ended 31 July 2019. What is the transition date to SFRS(I)?
9. Identify two areas for which SFRS(I) 1 provides mandatory exceptions.
Answers to Quick Quiz

1. • ACRA which administers the Companies Act
   • ASC which issues FRS and INT FRS as well as SFRS(I)
   • SGX which prescribes reporting requirements in its Rulebooks

2. The Companies Act (Cap 50) requires companies to prepare financial statements that give a true and fair view.

3. The IFRS Interpretations Committee

4. Due process comprises six stages:
   (i) Setting the agenda
   (ii) Planning the project
   (iii) Developing and publishing the discussion paper
   (iv) Developing and publishing the exposure draft
   (v) Developing and publishing the standard
   (vi) Procedures after the standard is issued

5. Singapore accounting standards are embodied in the Companies Act and accordingly, companies incorporated under the Companies Act are required to comply with them in preparing their financial statements.

6. Hong Kong (HKFRS), Malaysia (MFRS), South Korea (K-IFRS), Singapore (SFRS(I)).

7. The annual improvements projects form a streamlined process for dealing with a number of minor narrow scope amendments to standards.

8. 1 August 2017

2.1 Convergence

(a) **Investors**, both individual and corporate, would like to be able to compare the financial results of different companies internationally (as well as nationally) in making investment decisions. Differences in accounting practice and reporting can be a barrier to such cross-border analysis. There is a growing amount of international investment across borders, but there are few financial analysts experienced in international markets.

(b) **Multinational companies** would benefit from convergence for many reasons.
   - Better access to foreign investor funds
   - Aid internal communication of financial information
   - Easier appraisal of foreign entities for take-overs and mergers
   - Easier to comply with reporting requirements of overseas stock exchanges
   - Easier consolidation of foreign subsidiaries and associated companies
   - Possible reduction in audit costs
   - Easier transfer of accounting staff across national borders

(c) **Governments of developing countries** would save time and money by adopting international standards. If these were used internally, governments of developing countries could monitor the activities of foreign multinational companies within their own country, as these companies could not ‘hide’ behind foreign accounting practices which are difficult to understand.

(d) **Tax authorities**. It will be easier to calculate the tax liability of investors, including multinationals who receive income from overseas sources.

(e) **Regional economic groups** usually promote trade within a specific geographical region. This would be aided by common accounting practices within the region.

(f) **Large international accounting firms** would benefit as accounting and auditing would be much easier if similar accounting practices existed throughout the world.
This chapter revises the theory behind the formation of a conceptual framework and the Singapore ASC's Conceptual Framework for Financial Reporting, which you will have come across before.

It also introduces a standard, SFRS(I) 13 *Fair Value Measurement*, which impacts almost every topic in financial reporting, as you will see as you progress throughout this Textbook.

**Topic list**

1. A conceptual framework
2. The *Conceptual Framework for Financial Reporting*
3. Materiality
4. Measurement bases
5. SFRS(I) 13 *Fair Value Measurement*
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The Conceptual Framework for Financial Reporting</strong></td>
<td>2</td>
</tr>
<tr>
<td>Discuss the use of a Conceptual Framework in the setting of accounting standards.</td>
<td></td>
</tr>
<tr>
<td>Identify the relationship between accounting theory and practice.</td>
<td>2</td>
</tr>
<tr>
<td><strong>Measurement and Reporting (Assets)</strong></td>
<td>3</td>
</tr>
<tr>
<td>Evaluate the measurement bases adopted by accounting standard setters and explain different methods of measurement used for major classes of assets.</td>
<td></td>
</tr>
<tr>
<td><strong>Measurement and Reporting (Liabilities)</strong></td>
<td>3</td>
</tr>
<tr>
<td>Evaluate the measurement bases adopted by accounting standard setters and explain different methods of measurement used for major classes of liabilities.</td>
<td></td>
</tr>
<tr>
<td><strong>Emerging Trends</strong></td>
<td>1</td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments.</td>
<td></td>
</tr>
</tbody>
</table>

**ESSENTIAL READING**


1 **A conceptual framework**

**SECTION INTRODUCTION**

A conceptual framework provides a foundation upon which accounting standards are developed.

1.1 **The search for a conceptual framework**

**KEY TERM**

A *Conceptual Framework*, in the field we are concerned with, is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting. These theoretical principles provide the basis for the development of new accounting standards and the evaluation of those already in existence.

SFRS(I) operate under the *Conceptual Framework for Financial Reporting*. The financial reporting process is concerned with providing information that is useful in the business and economic decision-making process. Therefore a conceptual framework will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated to the user.
Although it is theoretical in nature, a conceptual framework for financial reporting has highly practical final aims.

The danger of not having a conceptual framework is demonstrated in the way some countries' standards have developed over recent years; standards tend to be produced in a haphazard and fire-fighting approach. Where an agreed framework exists, the standard-setting body acts as an architect or designer, rather than a fire-fighter, building accounting rules on the foundation of sound, agreed basic principles.

The lack of a conceptual framework also means that fundamental principles are tackled more than once in different standards, thereby producing contradictions and inconsistencies in basic concepts, such as those of prudence and matching. This leads to ambiguity and it affects the true and fair concept of financial reporting.

Another problem with the lack of a conceptual framework has become apparent in the USA. The large number of highly detailed standards produced by the Financial Accounting Standards Board (FASB) has created a financial reporting environment governed by specific rules rather than general principles. This would be avoided if a cohesive set of principles were in place.

A conceptual framework can also bolster standard setters against political pressure from various 'lobby groups' and interested parties. Such pressure would only prevail if it were acceptable under the conceptual framework.

1.2 Advantages of a conceptual framework

The advantages arising from using a conceptual framework may be summarised as follows.

(a) The situation is avoided whereby standards are being developed on a piecemeal basis, where a particular accounting problem is recognised as having emerged, and resources were then channelled into standardising accounting practice in that area, without regard to whether that particular issue was necessarily the most important issue remaining at that time without standardisation.

(b) As stated above, the development of certain standards (particularly national standards) has been subject to considerable political interference from interested parties. Where there is a conflict of interest between user groups on which policies to choose, policies deriving from a conceptual framework will be less open to criticism that the standard-setter buckled to external pressure.

(c) Some standards may concentrate on the statement of profit or loss and other comprehensive income whereas some may concentrate on the valuation of net assets (statement of financial position).

The objectives of the Conceptual Framework are covered in Section 2.1.

1.3 Disadvantages of a conceptual framework

A counter-argument might be as follows.

(a) Financial statements are intended for a variety of users, and it is not certain that a single conceptual framework can be devised which will suit all users.

(b) Given the diversity of user requirements, there may be a need for a variety of accounting standards, each produced for a different purpose (and with different concepts as a basis).

(c) It is not clear that a conceptual framework makes the task of preparing and then implementing standards any easier than without a framework.

SECTION SUMMARY

A conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting. There are advantages and disadvantages to having a conceptual framework.
2 The Conceptual Framework for Financial Reporting

SECTION INTRODUCTION

The IASB's 2010 Conceptual Framework for Financial Reporting was adopted by the Singapore Accounting Standards Council (ASC) in 2011. In March 2018, the IASB completed a project to revise the existing Conceptual Framework; this 2018 Conceptual Framework not been adopted by the ASC at the time of writing (August 2018).

The Conceptual Framework for Financial Reporting as issued by the ASC in 2011 is as follows:

- Chapter 1
  The objective of general purpose financial reporting (Section 2.2)

- Chapter 2
  The reporting entity (to be issued)

- Chapter 3
  Qualitative characteristics of useful financial information (Section 2.3)

- Chapter 4
  Remaining text of the 1989 Framework

  - Underlying assumption (Section 2.4)
  - The elements of financial statements (Section 2.5)
  - Recognition of the elements of financial statements (Section 2.6)
  - Measurement of the elements of financial statements (Section 2.7)
  - Concepts of capital and capital maintenance (Section 2.8)

As you can see, parts of the Conceptual Framework are based on the IASB Framework for the Preparation and Presentation of Financial Statements produced in 1989. As a result of an IASB/FASB joint project the plan had been to gradually replace the original Framework. This project was not completed with only Chapters 1 and 3 being issued. This unfinished Conceptual Framework was adopted by Singapore ASC in 2011. The project to replace the original Framework was reactivated as an IASB-only project and a revised Conceptual Framework was issued by the IASB in March 2018. The 2018 Conceptual Framework fills gaps in the existing Conceptual Framework, updates it and clarifies parts of it. For the purposes of the FR exam, the updated document is a current development rather than examinable in full and a summary of it is given in Section 2.9 of this chapter.

We will now look at the individual sections of the Conceptual Framework as it currently stands in more detail.
2.1 Introduction to the Conceptual Framework

The Introduction provides a list of the purposes of the Conceptual Framework:

(a) To assist the ASC in the development of future FRSs and its review of existing FRSs
(b) To assist in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by FRSs
(c) To assist national standard-setting bodies in developing national standards
(d) To assist preparers of financial statements in applying FRSs and in dealing with topics that have yet to form the subject of an FRS
(e) To assist auditors in forming an opinion as to whether financial statements comply with FRSs
(f) To assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with FRSs
(g) To provide those who are interested in the work of the ASC with information about its approach to the formulation of FRSs

The Conceptual Framework is not an FRS and so does not overrule any individual FRS. In the (rare) case of conflict between an FRS and the Conceptual Framework, the FRS will prevail.

2.2 The Objective of General Purpose Financial Reporting

The Conceptual Framework states that:

‘The objective of general purpose financial reporting is to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.’

These users need information about:

- The economic resources of the entity
- The claims against the entity
- Changes in the entity’s economic resources and claims

Information about the entity’s economic resources and the claims against it helps users to assess the entity's liquidity and solvency and its likely needs for additional financing.

Information about a reporting entity's financial performance (the changes in its economic resources and claims) helps users to understand the return that the entity has produced on its economic resources. This is an indicator of how efficiently and effectively management has used the resources of the entity and is helpful in predicting future returns.

The Conceptual Framework makes it clear that this information should be prepared on an accruals basis.

Information about a reporting entity's cash flows during a period also helps users assess the entity's ability to generate future net cash inflows and gives users a better understanding of its operations.

General purpose financial reports are not designed to reflect the entity's value. They provide information to assist users in estimating the entity's value.

2.3 Qualitative characteristics of useful financial information

Qualitative characteristics are attributes that make financial information useful to users.

Chapter 3 distinguishes between fundamental and enhancing qualitative characteristics, for analysis purposes. In order for financial information to be useful, it must be relevant and faithfully represent what it purports to represent.
The two fundamental qualitative characteristics are:

(a) **Relevance**: relevant information has predictive value or confirmatory value, or both. It is capable of making a difference in the decisions made by users. The predictive value and confirmatory value of financial statements are inter-related. For example, information on revenue in the current year is used as a basis of predicting revenue in future years and also as a point of comparison with predictions made in prior years in respect of the current year.

The relevance of information is affected by its nature and its materiality. Materiality is a subsidiary concept of relevance. Materiality sets the threshold for determining whether an item is relevant. Materiality is entity-specific which refers to a different decision being made should information be omitted or misstated. Therefore, the Singapore ASC does not specify nor predetermine the amount and degree of materiality in a particular situation.

(b) **Faithful representation**: information must be complete, neutral and free from error.

Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena but must faithfully represent the phenomena that it purports to represent.

A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. For example, a complete depiction of a group of assets would include a description of the assets, a numerical depiction of the assets and a description of what the numerical depiction represents eg cost or fair value.

A neutral depiction is without bias in the selection or presentation of financial information. This means that information must not be manipulated in any way in order to influence the decisions of users.

Free from error means there are no errors or omissions in the description of the phenomenon and no errors made in the process by which the financial information was produced. It does not mean that no inaccuracies can arise, particularly where estimates have to be made.

**Substance over form**

This is not a separate qualitative characteristic under the Conceptual Framework. The ASC says that to do so would be redundant because it is implied in faithful representation. Faithful representation of a transaction is only possible if it is accounted for according to its substance and economic reality.

### 2.3.1 Enhancing qualitative characteristics

The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable. The enhancing characteristics are therefore comparability, verifiability, timeliness and understandability.

(a) **Comparability**

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

Consistency, although related to comparability, is not the same. It refers to the use of the same methods for the same items (ie consistency of treatment) either from period to period within a reporting entity or in a single period across entities.

The disclosure of accounting policies is particularly important here. Users must be able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the accounts of different entities.
Comparability is **not the same as uniformity**. Entities should change accounting policies if those policies become inappropriate.

**Corresponding information** for preceding periods should be shown to enable comparison over time.

(b) **Verifiability**

Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. It means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation.

(c) **Timeliness**

Information may become less useful if there is a delay in reporting it. There is a **balance between timeliness and the provision of reliable information**.

If information is reported on a timely basis when not all aspects of the transaction are known, it may not be complete or free from error.

Conversely, if every detail of a transaction is known, it may be too late to publish the information because it has become irrelevant. The overriding consideration is how best to satisfy the economic decision-making needs of the users.

(d) **Understandability**

It is assumed that financial reports are prepared for users who have a **reasonable knowledge of business and economic activities** and who review and analyse the information diligently. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information on those phenomena might make the information easier to understand, but without it those reports would be incomplete and therefore misleading. Therefore matters should not be left out of financial statements simply due to their difficulty as even well-informed and diligent users may sometimes need the aid of an adviser to understand information about complex economic phenomena.

The cost constraint on useful financial reporting

This is a pervasive constraint, not a qualitative characteristic. When information is provided, its benefits must exceed the costs of obtaining and presenting it. This is a **subjective area** and there are other difficulties: others, not the intended users, may gain a benefit; also the cost may be paid by someone other than the users. It is therefore difficult to apply a cost-benefit analysis, but preparers and users should be aware of the constraint.
2.4 The underlying assumption
The 1989 Framework identified two underlying assumptions – accruals and going concern.
The Conceptual Framework makes it clear that financial information should be prepared on an accruals
basis but only identifies one underlying assumption – going concern. The going concern assumption
means that financial statements are prepared on the basis that the reporting entity will continue in
operation for the foreseeable future.

2.5 The elements of financial statements
Elements are the ‘broad classes’ that the financial effects of transactions are grouped into in financial
statements. The Conceptual Framework lays out two main groups of elements as follows.

![Elements of financial statements diagram]

Measurement of financial position in
Statement of financial position
- Assets
- Liabilities
- Equity

Measurement of performance in
Statement of profit or loss and
other comprehensive income
- Income
- Expenses

A process of sub-classification then takes place for presentation in the financial statements, eg expenses
are classified by their nature or function and assets and liabilities by degree of liquidity.

2.5.1 Financial position
We need to define the three terms listed under this heading above.

**KEY TERMS**

**ASSET** A resource controlled by an entity as a result of past events and from which
future economic benefits are expected to flow to the entity.

**LIABILITY** A present obligation of the entity arising from past events, the settlement of
which is expected to result in an outflow from the entity of resources embodying
economic benefits.

**EQUITY** The residual interest in the assets of the entity after deducting all its
liabilities.

(Conceptual Framework)

These definitions are important, but they do not cover the criteria for recognition of any of these items,
which are discussed in the next section of this chapter. This means that the definitions may include items
which would not actually be recognised in the statement of financial position because they fail to satisfy
the recognition criteria, particularly the probable flow of any economic benefit to or from the business.

Whether an item satisfies any of the definitions above will depend on the substance and economic reality
of the transaction, not merely its legal form. For example, consider redeemable preference shares (see
Chapter 16).
2.5.2 Assets

We can look in more detail at the components of the definitions given above.

**KEY TERM**

**FUTURE ECONOMIC BENEFIT** The potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production. *(Conceptual Framework)*

Assets are usually employed to produce goods or services for customers; customers will then pay for these goods and services. **Cash itself** renders a service to the entity due to its command over other resources.

The existence of an asset, particularly in terms of **control**, is not reliant on:

(a) **Physical form** (example patents and copyrights)
(b) **Legal title** (example leases)

Transactions or events **in the past** give rise to assets; those expected to occur in the future do not in themselves give rise to assets. For example, an intention to purchase a non-current asset does not, in itself, meet the definition of an asset.

2.5.3 Liabilities

Again we can look more closely at some aspects of the definition. An essential characteristic of a liability is that the entity has a **present obligation**.

**KEY TERM**

**OBLIGATION** A duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. *(Conceptual Framework)*

It is important to distinguish between a present obligation and a **future commitment**. A management decision to purchase assets in the future does not, in itself, give rise to a present obligation.

**Settlement** of a present obligation will involve the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. This may be done in various ways, not just by payment of cash.

Liabilities must arise from **past transactions or events**. In the case of, say, recognition of future rebates to customers based on annual purchases, the sale of goods in the past is the transaction that gives rise to the liability.

2.5.4 Provisions

Is a provision a liability?

**KEY TERM**

**PROVISION** A present obligation which satisfies the rest of the definition of a liability, even if the amount of the obligation has to be estimated. *(Conceptual Framework)*
**Question 3.1  Assets and liabilities**

Consider the following situations. In each case, does the named company have an asset or liability within the definitions given by the *Conceptual Framework*? Give reasons for your answer.

(a) Manufacturing Ltd has purchased a patent for $20,000. The patent gives the company sole use of a particular manufacturing process which will save $3,000 a year for the next five years.

(b) Semba Engineering paid a third party $10,000 to set up a car repair shop, on condition that priority treatment is given to cars from the company’s fleet.

(c) Deals on Wheels Trading provides an assurance warranty with every car sold.

---

**2.5.5 Equity**

Equity is defined above (Section 2.5.1) as a residual, but it may be sub-classified in the statement of financial position eg as stated capital (funds contributed by shareholders), retained earnings and so on. This will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. Some reserves are required by statute or other law, eg for the future protection of creditors. The amount shown for equity depends on the **measurement of assets and liabilities**. It has nothing to do with the market value of the entity’s shares.

**2.5.6 Performance**

Profit is used as a measure of performance, or as a basis for other measures (eg Earnings per share). It depends directly on the measurement of income and expenses, which in turn depend (in part) on the concepts of capital and capital maintenance adopted.

The elements of income and expense are therefore defined.

---

**KEY TERMS**

**INCOME** Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

**EXPENSES** Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

*(Conceptual Framework)*

Income and expenses can be presented in different ways in the statement of profit or loss and other comprehensive income, to provide information relevant for economic decision-making. For example, income and expenses which relate to continuing operations are distinguished from the results of discontinued operations.

**2.5.7 Income**

Both revenue and gains are included in the definition of income. Revenue arises in the course of ordinary activities of an entity.

---

**KEY TERM**

**GAINS** represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. They represent increases in economic benefits and as such they are no different in nature from revenue.

*(Conceptual Framework)*
Gains include those arising on the disposal of non-current assets. The definition of income also includes unrealised gains, eg on revaluation of marketable securities.

2.5.8 Expenses
The definition of expenses includes losses as well as those expenses that arise in the course of ordinary activities of an entity.

KEY TERM
Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity. Losses represent decreases in economic benefits and as such they are no different in nature from expenses.

(Conceptual Framework)

Losses include those arising on the disposal of non-current assets. The definition of expenses also includes unrealised losses, eg the fall in value of an investment.

2.6 Recognition of the elements of financial statements

KEY TERM
Recognition The process of incorporating in the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) The item has a cost or value that can be measured with reliability.

(Conceptual Framework)

Regard must be given to materiality (see Section 2.3).

2.6.1 Probability of future economic benefits
Probability here means the degree of uncertainty that the future economic benefits associated with an item will flow to or from the entity. This must be judged on the basis of the characteristics of the entity's environment and the evidence available when the financial statements are prepared.

2.6.2 Reliability of measurement
The cost or value of an item, in many cases, must be estimated. The Conceptual Framework states, however, that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Where no reasonable estimate can be made, the item should not be recognised, although its existence should be disclosed in the notes, or other explanatory material.

Items may still qualify for recognition at a later date due to changes in circumstances or subsequent events.

2.6.3 Assets which cannot be recognised
The recognition criteria do not cover items which many businesses may regard as assets. A skilled workforce is an undoubted asset but workers can leave at any time so there can be no certainty about the probability of future economic benefits. A company may have come up with a new name for its product which is greatly increasing sales but, as it did not buy the name, the name does not have a cost or value that can be reliably measured, so it is not recognised.
2.6.4 Recognition of items

We can summarise the recognition criteria for assets, liabilities, income and expenses, based on the definition of recognition given above.

<table>
<thead>
<tr>
<th>Item</th>
<th>Recognised in</th>
<th>When</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>The statement of financial position</td>
<td>It is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.</td>
</tr>
<tr>
<td>Liability</td>
<td>The statement of financial position</td>
<td>It is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.</td>
</tr>
<tr>
<td>Income</td>
<td>The statement of profit or loss and other comprehensive income</td>
<td>An increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.</td>
</tr>
<tr>
<td>Expenses</td>
<td>The statement of profit or loss and other comprehensive income</td>
<td>A decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.</td>
</tr>
</tbody>
</table>

2.7 Measurement of the elements of financial statements

A number of different measurement bases are used in financial statements, including historical cost, current cost, realisable (settlement) value and present value.

Measurement is defined as follows.

**KEY TERM**

**MEASUREMENT** The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of profit or loss and other comprehensive income.

(Conceptual Framework)

This involves the selection of a particular **basis of measurement**. A number of these are used to different degrees and in varying combinations in financial statements. They include the following.
KEY TERMS

HISTORICAL COST Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

CURRENT COST Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

REALISABLE (SETTLEMENT) VALUE

- REALISABLE VALUE The amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal.
- SETTLEMENT VALUE The undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

PRESENT VALUE A current estimate of the present discounted value of the future net cash flows in the normal course of business. (Conceptual Framework)

Note that realisable value applies to assets. Settlement value applies to liabilities.

Historical cost is the most commonly adopted measurement basis, but this is usually combined with other bases, eg inventory is carried at the lower of cost and net realisable value (SFRS(I) 1-2).

Note that the current Conceptual Framework does not include fair value as a measurement basis. The proposed new Conceptual Framework does, however, refer to fair value, and provides a definition that is in line with SFRS(I) 13. The new Conceptual Framework is discussed in further detail later in this chapter.

Example

A machine was purchased on 1 January 20X8 for $3 million – its original cost. It has a useful life of 10 years and under the historical cost convention it will be carried at original cost less accumulated depreciation. So in the financial statements at 31 December 20X9 it will be carried at:

$3m – ($3m/10 × 2) = $2.4m

The current cost of the machine, which will probably also be its fair value (realisable value), will be fairly easy to ascertain if it is not too specialised. For instance, two year old machines like this one may currently be changing hands for $2.5 million, so that will be an appropriate value.

The net realisable value of the machine will be the amount that could be obtained from selling it, less any costs involved in making the sale. If the machine had to be dismantled and transported to the buyer’s premises at a cost of $200,000, the NRV would be $2.3 million.

The present value of the machine will be the discounted value of the future cash flows that it is expected to generate. If the machine is expected to generate $500,000 per annum for the remaining 8 years of its life and if the company’s cost of capital is 10%, present value will be calculated as:

$500,000 × 5.335* = $2,667,500

* Cumulative present value of $1 per annum for 8 years discounted at 10%

Measurement bases are discussed in more detail in Section 3 of this chapter.
2.8 Concepts of capital and capital maintenance

In order to determine what is meant by profit, it is important to consider what is meant by capital. The conceptual framework describes two concepts of capital. The financial concept of capital refers to capital as the net assets or equity of the entity. The physical concept of capital refers to capital as the productive capacity of the entity.

Capital maintenance then describes what is meant by profit. A profit is earned under the concept of financial capital maintenance if there is an increase in net assets during the period under review (after considering transactions with owners). A profit is earned under the concept of physical capital maintenance if there is an increase in the operating capability of the entity during the period under review (after considering transactions with owners).

The concept of capital maintenance chosen by an entity will determine the accounting model used in the preparation of its financial statements. Most entities adopt a financial concept of capital.

2.9 Current developments

As previously mentioned, the IASB concluded its project to revise the Conceptual Framework in March 2018.

The revised Conceptual Framework:

- Fills the gaps in the previous Conceptual Framework by providing better guidance on the factors to be considered when selecting a measurement basis and new guidance on presentation, disclosure and derecognition.
- Updates the existing Conceptual Framework by the definitions of asset and liability and the criteria for including them in the financial statements
- Clarifies concepts in the existing Conceptual Framework by prudence, stewardship, measurement uncertainty and substance over form.

2.9.1 Contents of the 2018 Conceptual Framework

The chapters of the 2018 Conceptual Framework are as follows:

Chapter 1 The objective of financial reporting
Chapter 2 Qualitative characteristics of useful financial information
Chapter 3 Financial statements and the reporting entity
Chapter 4 The elements of financial statements
Chapter 5 Recognition and derecognition
Chapter 6 Measurement
Chapter 7 Presentation and disclosure
Chapter 8 Concepts of capital and capital maintenance

2.9.2 The objective of financial reporting

This chapter was new when issued as Chapter 1 of the 2010 Conceptual Framework. Therefore it was not fundamentally changed for inclusion in the revised Conceptual Framework. The IASB has, however, clarified within this chapter why information used in assessing the stewardship of management is required to achieve the objective of financial reporting:
Users make decisions about:

- Buying, selling or holding equity or debt instruments
- Providing or settling loans and other credit lines
- Voting or otherwise influencing management actions.

In order to make these decisions, users assess:

- Prospects for future net cash inflows
- Management's stewardship of the entity's economic resources

To make these assessments, users require information about:

- The entity's economic resources, claims against the entity and changes in resources and claims
- How efficiently and effectively the management has discharged its responsibilities to use the entity's economic resources.

2.9.3 Qualitative characteristics of useful financial information

The qualitative characteristics of useful financial information are unchanged from the 2010 Conceptual Framework: for information to be useful it must possess the fundamental characteristics of faithful representation and relevance; the usefulness of information is enhanced by comparability, verifiability, timeliness and understandability.

The 2018 Conceptual Framework does, however, clarify the roles of prudence, substance over form and measurement uncertainty when assessing the usefulness of information:

(a) Prudence is the exercise of caution when making judgments under conditions of uncertainty; it does not allow for overstatement or understatement of assets, liabilities, income or expenses. The exercise of prudence supports neutrality and so contributes to faithful representation.

(b) An explicit statement is made that a faithful representation reports the substance of a transaction rather than legal form.

(c) Measurement uncertainty is identified as one factor that can make financial statements less relevant, however it does not prevent information from being useful. In some cases measurement uncertainty is so high that the most useful information is information that is slightly less relevant but is subject to lower measurement uncertainty.

2.9.4 Financial statements and the reporting entity

This chapter is new and no equivalent was included in the previous Conceptual Framework.

A reporting entity is an entity that chooses, or is required, to present financial statements (statement of financial position, statement of financial performance and other statements and notes). Financial statements are usually prepared on the going concern basis, however if they are prepared on a different basis this must be described.

It need not be a legal entity and can comprise a portion of a single entity or a group of two or more entities.
Financial statements provide information about a reporting entity:

(a) Consolidated financial statements provide information about the assets, liabilities, equity, income and expenses of both the parent and its subsidiaries as a single entity, which is useful to users in their assessment of future net cash inflows to the parent.

(b) Unconsolidated financial statements provide information about the assets, liabilities, equity, income and expenses of the parent only. This is useful as claims against the parent do not typically give the holder a claim against the subsidiaries, and in some jurisdictions, distributions to holders of equity depend on the distributable reserves of the parent.

(c) Combined financial statements provide information about the assets, liabilities, equity, income and expenses of two or more entities that are not linked by a parent–subsidiary relationship.

2.9.5 The elements of financial statements

Within this chapter, the definitions of asset and liability contained within the 2010 Conceptual Framework are updated and consequential amendments are made to the definitions of income and expense. The definition of equity is unchanged.

**Asset**

A present economic resource controlled by the entity as a result of past events.

An economic resource is a right that has the potential to produce economic benefits.

**Liability**

A present obligation of the entity to transfer an economic resource as a result of past events.

An obligation is a duty or responsibility that the entity has no practical ability to avoid.

**Income**

Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

**Expenses**

Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

Unlike the old definitions, the new definitions of asset and liability do not refer to an ‘expected’ flow of future economic benefits. There is no requirement for a flow of economic benefits to be certain or even probable, however the probability of a flow of economic benefits is likely to affect the decision as to whether an asset or liability is recognised and, if so, how it is measured.

The 2018 Conceptual Framework also provides guidance on the unit of account to which recognition criteria and measurement concepts are applied (ie whether they are applied to individual assets and liabilities or groups of each). The guidance requires that a unit of account should be selected that provides relevant information and a faithful representation of the substance of the transaction or event from which the asset or liability has arisen.

2.9.6 Recognition and derecognition

The recognition criteria are revised to refer explicitly to the qualitative characteristics of useful information rather than to refer to probable economic benefits and reliable measurement.

An asset or liability is recognised if such recognition provides users with:

- Relevant information about the asset or liability
- A faithful representation of the asset or liability (and resulting income or expense)
- Information that results in benefits exceeding the cost of providing that information
These criteria may not be met where one or more of the following exists:

- Uncertainty over whether an asset or liability exists
- A low probability of future inflows (or outflows) of economic benefits
- A high level of measurement uncertainty such that the resulting information has little relevance

New guidance on derecognition is also included in the Conceptual Framework, which aims to faithfully represent the assets and liabilities (if any) retained after the transaction and the change in the entity's assets and liabilities as a result of the transaction.

- Derecognition of an asset normally occurs when the entity loses control of all or part of the recognised asset.
- Derecognition of a liability normally occurs when the entity no longer has a present obligation for all or part of the recognised liability.

### 2.9.7 Measurement

The 2018 Conceptual Framework introduces detailed guidance on measurement. It refers to two measurement bases: historical cost and current value (which includes fair value as defined in IFRS 13 (SFRS(I) 13), value in use (assets), fulfilment value (liabilities) and current cost.

The fundamental characteristics of relevance and faithful representation should be considered when selecting a measurement basis:

- The relevance of a measurement basis is affected by:
  - The characteristics of the asset or liability (e.g., the variability of cash flows)
  - Its contribution to future cash flows (e.g., whether cash flows are produced directly or indirectly)

- Whether a measurement basis can provide a faithful representation is affected by:
  - Measurement inconsistency (e.g., accounting mismatches)
  - Measurement uncertainty

Cost constraints should also be considered when selecting a measurement basis.

### 2.9.8 Presentation and disclosure

The 2018 Conceptual Framework guidance on presentation and disclosure is new and there was no equivalent guidance in the 2010 Conceptual Framework.

(a) In principle all income and expenses are included in profit or loss; in exceptional circumstances, the IASB may include income and expense arising from a change in the value of an asset or liability in other comprehensive income in order to provide more relevant information or a more faithful representation.

(b) A decision about including income and expenses in other comprehensive income can be made only by the Board in setting standards.

(c) In principle, income and expenses included in other comprehensive income are reclassified to profit or loss when doing so would enhance the relevance or faithful representation of the information in the statement of profit or loss for that period. A statement about whether and when income and expenses included in other comprehensive income should be recycled can be made only by the Board in setting standards.
2.9.9 Capital and capital maintenance
With the exception of some minor changes to terminology this chapter is unchanged from that included within the current Conceptual Framework.

SECTION SUMMARY
The Conceptual Framework provides the principles and concepts which underlie accounting standards. It identifies two fundamental qualitative characteristics, being relevance and faithful representation, and four enhancing qualitative characteristics, being comparability, verifiability, timeliness and understandability. The Conceptual Framework also identifies the elements of the financial statements as assets, liabilities, equity, income and expenses and provides recognition criteria and measurement bases for these elements. It is currently being reviewed by the IASB.

3 Materiality

SECTION INTRODUCTION
The IASB issued Practice Statement 2 Making Materiality Judgements in September 2017; this was issued by the ASC as an SFRS(I) Practice Statement in August 2018. This provides guidance to help management apply the concept of materiality when preparing general purpose financial statements in accordance with SFRS(I).

As we saw in Section 2, the Conceptual Framework includes a consideration of materiality within its discussion of relevance. It states that information is material if omitting it or misstating it could influence users' decisions. Therefore materiality is entity-specific, based on the nature or magnitude, or both, of given items. As a result, a quantitative threshold of materiality cannot be specified.

Whether information is material is a matter of judgment and the Practice Statement provides guidance so that management can understand the concept of materiality and correctly apply it in financial statements. This will help to ensure, for example, that notes to the financial statements are relevant to a particular organisation, rather than being 'boilerplate' disclosures ie copied from standards or illustrative financial statements.

3.1 Guidance in the practice statement
The practice statement discusses the general characteristics of materiality and interaction with local regulations before providing a four-step process to apply when making materiality judgments and considering the specific topics of prior-period information, errors, information about covenants and interim reporting.

3.1.1 Objective and scope
The Practice Statement aims to help preparers of financial statements make judgments about what information is likely to be material to the primary users of financial statements. The guidance may also help other parties to understand how materiality judgments are made.

3.1.2 General characteristics
The Practice Statement expands on existing guidance on materiality that is contained within the Conceptual Framework, SFRS(I) 1-1 Presentation of Financial Statements and SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors. It discusses materiality within the context of meeting the information needs of the primary users (existing and potential investors, lenders and other creditors) and emphasises the following:
• SFRS(I) recognition and measurement requirements need only be applied when the effect of doing so is material.
• Disclosures specified in SFRS(I) are not required if the disclosure is not material.
• Financial statements should provide information that satisfies the common needs of primary users (rather than a particular group's specific needs).
• When making materiality judgments, management should assess whether information can reasonably be expected to influence primary user's decisions rather than whether information would be capable of changing their decisions.
• Management should disregard whether information is available from alternative sources when assessing whether it is material and whether it should be disclosed.

3.1.3 Interaction with local laws and regulation
The Practice Statement identifies that an entity can provide additional information in order to meet legal or regulatory requirements even if that information is not deemed to be material in the context of SFRS(I). The additional information should not, however, obscure information that is material according to SFRS(I)s.

3.1.4 Four-step process
The Practice Statement provides a four-step process as an example of how management could make materiality judgments when preparing financial statements. This is not a definitive method and other methods of assessing materiality may be appropriate:

1. Identify potentially material information, considering both SFRS(I) and the information needs of primary users.
2. Assess whether this information is material by considering quantitative factors (e.g., the size of a transaction) and qualitative factors (e.g., the involvement of a related party).
3. Organise the information that is considered to be material in the draft financial statements in a way that communicates the information clearly and concisely to primary users.
4. Review the draft financial statements as a whole considering whether all material information has been identified and whether materiality has been considered in aggregate on the basis of the full set of financial statements.

3.1.5 Specific topics
The Practice Statement includes details on how materiality judgments should be applied to the following specific topics:

Prior period information
Prior period disclosures should be expanded or summarised to suit the needs of the current year, regardless of how much information was included in the prior year's financial statements.
Errors
Where an error is considered to be individually material, correction cannot be avoided simply because other errors offset the material error.
When assessing materiality of errors on a cumulative basis, management should consider any further accumulation of errors in the current period and whether a change in circumstances would result in a different assessment of materiality in the current period.

Covenants
When considering the materiality of information about a covenant or breach of covenant, management should consider the consequence of breaching a covenant and the likelihood of doing so.
- If the consequence of breaching a covenant would be material, then information about the covenant would likely be material; and
- The more likely a breach of a covenant, the more likely that information about the covenant would be material.

Interim reporting
Management should adopt the same materiality process for the preparation of both annual and interim accounts. It should, however, consider that the time period and purpose of an interim report differs from that of an annual report.
Where information that is material to the interim period was disclosed in the latest annual financial statements, it need not be reproduced in the interim report unless an update is required.

3.2 Status of a practice statement
A practice statement is non-mandatory guidance, and therefore compliance is only necessary if required by a local regulator. The IASB decided to issue the materiality guidance as a practice statement rather than a standard in order to avoid conflict with national legal frameworks.

4 Measurement bases

SECTION INTRODUCTION
Each of the available measurement bases has benefits and drawbacks.

As we have already identified, the most common measurement basis in the financial statements is historical cost. This has a number of advantages and disadvantages in comparison with current value measurement. The following discussion compares historical cost and current cost accounting. Note that the discussion in this section may not reflect the way in which assets are measured in accordance with SFRS(1)s.

4.1 Advantages of historical cost accounting
Historical cost accounting has a number of advantages. The most important ones are:
(a) Amounts used are as actually transacted so are assumed to be objective and free from bias.
(b) Amounts are reliable; they can be verified by reference to invoices and other documents (see Conceptual Framework paragraph 4.41 which considers reliability of measurement).
(c) Amounts in the statement of cash flows can be derived from amounts in the statement of financial position.
(d) Opportunities for creative accounting are fewer than under systems which allow management to apply their judgment to the valuation of assets.

(e) It is one of the earliest forms of cost measurement and is easily understood.

4.2 Disadvantages of historical cost accounting

Historical cost accounting has a number of disadvantages. They arise as particular problems in periods of inflation. The main ones are:

(a) It can lead to misstatement of assets in the statement of financial position. A building purchased 50 years ago will appear at the price that was paid for it 50 years ago.

(b) Because assets are misstated, depreciation will also be misstated.

(c) When inventory prices are rising and the company is operating a first-in-first-out (FIFO) system, the cheapest inventories are being charged to cost of sales and the most expensive are being designated as closing inventory in the statement of financial position. It could be argued that the cost of sales figure is artificially low as a result.

(d) An organisation selling in an inflationary market will see its revenue and profits rise, but this is ‘paper profit’, distorted by the understated depreciation and cost of sales.

From these disadvantages various issues arise:

(a) Understatement of assets will depress a company’s share price and make it vulnerable to takeover. In practice, listed companies avoid this by revaluing land and buildings in line with market values.

(b) Understated depreciation and understated cost of sales lead to overstatement of profits, compounded by price inflation.

(c) Overstated profits can lead to too much being distributed to shareholders, leaving insufficient amounts for investment.

(d) Overstated profits will lead shareholders to expect higher dividends and employees to demand higher wages.

(e) Overstated profits lead to overstated tax liability.

During periods where price inflation is low, profit overstatement will be marginal. The disadvantages of historical cost accounting become most apparent in periods of inflation. It was during the inflationary period of the 1970s that alternatives were sought and that an attempt was made to introduce current cost accounting (CCA). As inflation came back under control, the debate died down, but it is becoming increasingly recognised that historical cost accounting has shortcomings which need to be addressed.

4.3 Current cost accounting

The conceptual basis of CCA is that the value of assets consumed or sold, and the value of assets in the statement of financial position, should be stated at their value to the business (also known as ‘deprival value’).

Key Term

The deprival value of an asset is the loss which a business entity would suffer if it were deprived of the use of the asset.

‘Value to the business’ is the required method of valuation in current cost accounting, because it reflects the extra funds which would be required to maintain the operating capability of the business entity if it suddenly lost the use of an asset. Value to the business, or deprival value, can be any of the following values.
3: The conceptual framework  |  PART A FINANCIAL REPORTING FRAMEWORK

(a) **Replacement cost**: in the case of non-current assets, it is assumed that the replacement cost of an asset would be its net replacement cost (NRC), its gross replacement cost minus an appropriate provision for depreciation to reflect the amount of its life already 'used up'.

(b) **Net realisable value** (NRV): the cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal, net of any disposal costs.

(c) **Economic value** (EV), or value in use: what the existing asset will be worth to the company over the rest of its useful life.

The choice of deprival value from one of the three values listed will depend on the particular circumstances relevant to each entity.

**If the asset is worth replacing, its deprival value will always be net replacement cost.**

If an asset is not worth replacing, the deprival value will be NRV or EV. However, there are many assets which will not be replaced either:

(a) Because the asset is **technologically obsolete**, and has been (or will be) superseded by more modern equipment; or

(b) Because the business is changing the nature of its operations and will not want to continue in the same line of business once the asset has been used up.

Such assets, even though there are reasons not to replace them, would still be valued (usually) at net replacement cost, because this 'deprival value' still provides an estimate of the operating capability of the company.

### 4.3.1 Advantages

There are a number of advantages of current cost accounting:

(a) By excluding holding gains from profit, CCA can be used to indicate whether the dividends paid to shareholders will **reduce the operating capability** of the business.

(b) Assets are valued after management has considered the opportunity cost of holding them, and the expected benefits from their future use. CCA is therefore a useful guide for management in deciding whether to hold or sell assets.

(c) It is **relevant** to the needs of information users in:

   (i) Assessing the stability of the business entity

   (ii) Assessing the vulnerability of the business (e.g. to a takeover), or the liquidity of the business

   (iii) Evaluating the performance of management in maintaining and increasing the business substance

   (iv) Judging future prospects

(d) It can be **implemented fairly easily** in practice, assuming that there is a ready market for items, by making simple adjustments to the historical cost accounting profits. A current cost statement of financial position can also be prepared with reasonable simplicity where an asset or liability has a ready market. Where no market exists, the costs of determining current cost may outweigh the benefits of using it.

### 4.3.2 Disadvantages

Disadvantages include:

(a) It is not always possible to make valuations of EV or NRV without **subjective judgments** (in particular when there is no reliable market value of the asset). The measurements used are therefore not always objective.
(b) It can be difficult to decide how to provide an estimate of replacement costs for non-current assets, if that method of valuation is deemed appropriate.

(c) The mixed value approach to valuation means that some assets will be valued at replacement cost, but others will be valued at net realisable value or economic value. It is arguable that the total assets will, therefore, have an aggregate value which is not particularly meaningful because of this mixture of different concepts. (Although SFRS(I) 1-16 requires all assets within the same class to be measured in the same way (SFRS(I) 1-16 paragraph 36) different measurement methods may be used for different classes.)

(d) It can be argued that ‘deprival value’ is an unrealistic concept, because the business entity has not been deprived of the use of the asset. This argument is one which would seem to reject the fundamental approach to ‘capital maintenance’ on which CCA is based.

SECTION SUMMARY

Although historical cost is the most commonly used measurement basis in practice, and has advantages, it also has a number of disadvantages. Alternatives to historical cost accounting include current cost accounting, under which elements are measured at deprival cost. Again this system of accounting has a number of advantages and disadvantages.

5 SFRS(I) 13 Fair Value Measurement

SECTION INTRODUCTION

SFRS(I) 13 Fair Value Measurement gives extensive guidance on how the fair value of assets and liabilities should be established.

A number of accounting standards require the use of fair value in measuring elements of the financial statements. Historically, guidance on establishing fair value was included in each relevant accounting standard, however in May 2011 the IASB published IFRS 13, now adopted by the ASC as SFRS(I) 13 Fair Value Measurement, as a single source of fair value measurement guidance to which most other standards defer.

5.1 Objective

SFRS(I) 13 sets out to:

- Define fair value
- Set out in a single SFRS(I) a framework for measuring fair value
- Require disclosure about fair value measurements

It does not, however, stipulate when fair value can or should be used.

5.2 Definitions

SFRS(I) 13 defines fair value as ‘the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date’.

The previous definition used in standards was ‘the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction’.
The price which would be received to sell the asset or paid to transfer (not settle) the liability is described as the 'exit price' and this is the definition used in US GAAP. Although the concept of the 'arm's length transaction' has now gone, the market-based current exit price retains the notion of an exchange between unrelated, knowledgeable and willing parties.

5.3 Scope

SFRS(I) 13 applies when another SFRS(I) requires or permits fair value measurements or disclosures. The measurement and disclosure requirements do not apply in the case of:

(a) Share-based payment transactions within the scope of SFRS(I) 2 Share-based Payment
(b) Leasing transactions accounted for in accordance with SFRS(I) 16 Leases
(c) Measurements that have some similarities to fair value but are not fair value such as net realisable value as in SFRS(I) 1-2 Inventories or value in use as in SFRS(I) 1-36 Impairment of Assets

Disclosures are not required for:

(a) Plan assets measured at fair value in accordance with SFRS(I) 1-19 Employee Benefits
(b) Plan investments measured at fair value in accordance with SFRS(I) 1-26 Accounting and Reporting by Retirement Benefit Plans
(c) Assets for which the recoverable amount is fair value less disposal costs under SFRS(I) 1-36 Impairment of Assets

5.4 Measurement

Fair value is a market-based measurement, not an entity-specific measurement. It focuses on assets and liabilities and on exit (selling) prices. It also takes into account market conditions at the measurement date. In other words, it looks at the amount for which the holder of an asset could sell it and the amount which the holder of a liability would have to pay to transfer it. It can also be used to value an entity’s own equity instruments.

Because it is a market-based measurement, fair value is measured using the assumptions that market participants would use when pricing the asset or liability, taking into account any relevant characteristics of the asset or liability.

The approach to fair value measurement prescribed by SFRS(I) 13 requires that an entity determines:

- The particular asset or liability that is the subject of the measurement and its unit of account
- For a non-financial asset, the highest and best use of that asset
- The principal (or most advantageous) market for the asset and liability
- The valuation technique(s) appropriate for the measurement

5.4.1 Unit of account

Fair value measurements are based on an asset or a liability’s unit of account, which is specified by each SFRS(I) where a fair value measurement is required. Fair value measurement may be applied to a stand-alone asset or liability or a group of assets and/or liabilities. For most assets and liabilities, the unit of account is the individual asset or liability, but in some instances may be a group of assets or liabilities.

For example, a premium or discount on a large holding of the same shares is not considered when measuring fair value if the market’s normal daily trading volume is not sufficient to absorb the quantity held by the entity. The quoted price per share in an active market is used.

However, a control premium is considered when measuring the fair value of a controlling interest, because the unit of account is the controlling interest. Similarly, a discount for lack of control is considered when measuring a non-controlling interest.
5.4.2 Highest and best use (non-financial assets)

For **non-financial assets** the fair value measurement looks at the use to which the asset can be put. It takes into account the ability of a market participant to generate economic benefits by using the asset in its **highest and best** use.

**Example**

Pacific Properties Ltd owns land that is currently developed for industrial use as a site for a manufacturing plant. The land could alternatively be used as a site for a block of apartments.

How is the fair value of the land determined?

**Solution**

The fair value of the land is based on the highest and best use. Therefore fair value is the higher of:

1. The price that would be received to sell the land as currently developed for industrial use, or
2. The price that would be received to sell the land as a vacant site for residential use. In this case fair value should take into account the costs of demolishing the existing manufacturing plant and any other costs necessary to convert the land to a vacant site.

5.4.3 Principal or most advantageous market

It is assumed that the transaction to sell the asset or transfer the liability takes place either:

(a) In the **principal market** for the asset or liability; or
(b) In the absence of a principal market, in the **most advantageous** market for the asset or liability

The principal market is the market which is the most liquid (has the greatest volume and level of activity) for that asset or liability. The most advantageous market is the market that maximises the amount that would be received to sell the asset (or minimises the amount that would be paid to transfer the liability), after taking into account transaction costs and transport costs.

Fair value is not adjusted for transaction costs. Under SFRS(I) 13, these are not a feature of the asset or liability, but may be taken into account when determining the most advantageous market.

**Example**

**Principal or most advantageous market**

An asset is sold in two active markets, Market X and Market Y, at $58 and $57, respectively. Décor Ltd does business in both markets and can access the price in those markets for the asset at the measurement date as follows.

<table>
<thead>
<tr>
<th></th>
<th>Market X</th>
<th>Market Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>$58</td>
<td>$57</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>(4)</td>
<td>(3)</td>
</tr>
<tr>
<td>Transport costs</td>
<td>(4)</td>
<td>(2)</td>
</tr>
<tr>
<td></td>
<td><strong>50</strong></td>
<td><strong>52</strong></td>
</tr>
</tbody>
</table>

Remember that fair value is not adjusted for transaction costs. Under SFRS(I) 13, these are not a feature of the asset or liability, but may be taken into account when determining the most advantageous market.

What is the fair value of the asset?
Solution

If Market X is the principal market for the asset (ie the market with the greatest volume and level of activity for the asset), the fair value of the asset would be $54, measured as the price that would be received in that market ($58) less transport costs ($4) and ignoring transaction costs.

If neither Market X nor Market Y is the principal market for the asset, Décor must measure the fair value of the asset using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account both transaction costs and transport costs (ie the net amount that would be received in the respective markets).

The maximum net amount (after deducting both transaction and transport costs) is obtainable in Market Y ($52, as opposed to $50). But this is not the fair value of the asset. The fair value of the asset is obtained by deducting transport costs but not transaction costs from the price received for the asset in Market Y: $57 less $2 = $55.

5.5 Valuation techniques

In order to establish the fair value of items, a valuation technique must be used.

According to SFRS(I) 13: ‘An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.’

In certain cases valuation techniques are straightforward, for example in the case of quoted securities with an active market. In this case, fair value is determined based on quoted prices. In other situations more complex valuation techniques must be used, for example in the case of an unquoted subsidiary or associate investment.

Even where there are quoted prices for an item, SFRS(I) 13 acknowledges that when market activity declines an entity may have to change its valuation technique or use multiple techniques to measure fair value. In this case the emphasis must be on whether a transaction price is based on an orderly transaction, rather than a forced sale.

5.5.1 Valuation approaches

SFRS(I) 13 identifies three valuation approaches which are defined in Appendix A of the standard.

(a) Income approach. Valuation techniques that convert future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

(b) Market approach. A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business.

(c) Cost approach. A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

Entities must use a valuation technique (or techniques) consistent with one of these three approaches to measure fair value in a given situation. A change of valuation technique is considered to be a change of accounting estimate in accordance with SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors, and must be disclosed in the financial statements.

5.5.2 Inputs to valuation techniques

Entities should maximise the use of relevant observable inputs and minimise the use of unobservable inputs.
The standard establishes a three-level hierarchy for the inputs that valuation techniques use to measure fair value:

<table>
<thead>
<tr>
<th>Level 1 inputs</th>
<th>Level 2 inputs</th>
<th>Level 3 inputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.</td>
<td>Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, eg quoted prices for similar assets in active markets or for identical or similar assets in non-active markets or use of quoted interest rates for valuation purposes. Other examples are provided in SFRS(I) 13 para B35.</td>
<td>Unobservable inputs for the asset or liability, ie using the entity’s own assumptions about market exit value. Examples are provided in SFRS(I) 13 para B36.</td>
</tr>
</tbody>
</table>

Level 3 inputs are used to measure fair value to the extent that relevant observable inputs are not available, so allowing for situations where there is little, if any, market activity for an asset at the measurement date.

The fair value measurement of an item is categorised in its entirety at the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement.

### 5.5.3 Examples of inputs used to measure fair value

<table>
<thead>
<tr>
<th>Asset or liability</th>
<th>Input</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Level 1</strong></td>
<td></td>
</tr>
<tr>
<td>Equity shares in a listed company</td>
<td>Unadjusted quoted prices in an active market</td>
</tr>
<tr>
<td><strong>Level 2</strong></td>
<td></td>
</tr>
<tr>
<td>Licensing arrangement arising from a business combination</td>
<td>Royalty rate in the contract with the unrelated party at inception of the arrangement</td>
</tr>
<tr>
<td>Cash-generating unit</td>
<td>Valuation multiple (eg a multiple of earnings or revenue or a similar performance measure) derived from observable market data, eg from prices in observed transactions involving comparable businesses</td>
</tr>
<tr>
<td>Finished goods inventory at a retail outlet</td>
<td>Price to customers adjusted for differences between the condition and location of the inventory item and the comparable (ie similar) inventory items</td>
</tr>
<tr>
<td>Building held and used</td>
<td>Price per square metre derived from observable market data, eg prices in observed transactions involving comparable buildings in similar locations</td>
</tr>
<tr>
<td><strong>Level 3</strong></td>
<td></td>
</tr>
<tr>
<td>Cash-generating unit</td>
<td>Financial forecast (eg of cash flows or profit or loss) developed using the entity’s own data</td>
</tr>
<tr>
<td>Three-year option on exchange-traded shares</td>
<td>Historical volatility, ie the volatility for the shares derived from the shares’ historical prices</td>
</tr>
<tr>
<td>Asset or liability</td>
<td>Input</td>
</tr>
<tr>
<td>-------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>Adjustment to a mid-market consensus (non-binding) price for the swap developed using data not directly observable or otherwise corroborated by observable market data</td>
</tr>
</tbody>
</table>

The more subjective the inputs to the calculation of fair values, the more important it is to check the veracity of the of the data (see Chiu Teng @ Kallang v Singapore Land Authority [2014] www.straitstimes.com/breaking-news/money/story/singapore-property-developer-fails-judicial-review-bid-over-differential-p).

5.5.4 Additional points

SFRS(I) 13 makes the following additional points about fair values and the use of different valuation techniques and inputs:

(a) In certain cases a single valuation technique is appropriate (eg when valuing quoted shares); in other cases multiple valuation techniques may be appropriate (eg for an SFRS(I) 1-36 cash-generating unit). If multiple techniques are used, fair value is the point within the range of values that is most representative of fair value in the circumstances.

(b) Certain techniques are better suited to particular types of business, for example an asset based approach is relevant to property companies whilst an income approach is more relevant to service businesses. It is likely that valuation will be based on some unobservable inputs and as a result the overall fair value will be classified as a Level 3 measurement.

(c) When determining the fair value of loans, counterparty credit risk must be taken into account ie the risk that the counterparty will fail to pay an amount of the loan. This may be achieved when using an income approach to valuation by applying a current market credit spread in the discount rate applied to the cash flows of the loan.

(d) If a quoted item has a bid price (the price that buyers are willing to pay) and an ask price (the price that sellers are willing to achieve), the price within the bid-ask spread that is most representative of fair value is used to measure fair value. The use of bid prices for financial assets and the use of asking prices for financial liabilities is permitted but not required. SFRS(I) 13 does not preclude the use of mid-market pricing.

5.6 Measuring liabilities

Fair value measurement of a liability assumes that that liability is transferred at the measurement date to a market participant, who is then obliged to fulfill the obligation. The obligation is not settled or otherwise extinguished on the measurement date.

5.6.1 Entity's own credit risk

The fair value of a liability reflects the effect of non-performance risk, which includes but is not limited to the entity's own credit risk (see Chapter 16 SFRS(I) 7 Financial Instruments: Disclosures). This may be different for different types of liabilities.

Example

Entity's own credit risk

Black Ltd and Blue Ltd individually enter into legal obligations to each pay $20,000 to Green Ltd in seven years in exchange for some goods.

Black Ltd has a very good credit rating and can borrow at 4%. Blue Ltd's credit rating is lower and it can borrow at 8%.

What is the fair value of the legal obligation that Black Ltd and that Blue Ltd must record in their financial statements?
Solution

The fair value of Black Ltd's promise is approximately $15,200. This is the present value of $20,000 in seven years at 4%.

The fair value of Blue Ltd's promise is approximately $11,660. This is the present value of $20,000 in seven years at 8%.

These two values are different, even though the amount and period are the same, due to the different risk profiles of the two companies.

(Present value can be obtained using PV tables or the PV function on a financial calculator.)

5.7 SFRS(I) 13 and business combinations

Fair value applies to business combinations because the acquirer is required to measure consideration given, assets acquired and liabilities assumed at fair value. This topic is covered later in this Textbook together with some further examples.

5.8 Disclosure

An entity must disclose information that helps users of its financial statements assess both of the following:

(a) For assets and liabilities that are measured at fair value on a recurring or non-recurring basis, the valuation techniques and inputs used to develop those measurements.

(b) For recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period. Disclosure requirements will include:

   (i) Reconciliation from opening to closing balances
   (ii) Quantitative information regarding the inputs used
   (iii) Valuation processes used by the entity
   (iv) Sensitivity to changes in inputs

You should read SFRS(I) 13:91–99 regarding minimum disclosures.

5.9 Advantages and disadvantages of fair value (v historical cost)

<table>
<thead>
<tr>
<th>Advantages of fair value</th>
<th>Disadvantages of fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value is a current value and therefore more relevant to users' decision making processes.</td>
<td>(a) Where the fair value measurement of an item is categorised as Level 2 or 3, inputs are subjective and the reliability of the valuation is reduced.</td>
</tr>
<tr>
<td>(a) The financial statements of entities that measure items at up-to-date fair value are comparable on the same terms. This is not the case where historical cost is applied due to the varying dates on which assets are acquired and liabilities assumed.</td>
<td>(b) Determining fair values may be a time-consuming and costly process. This is particularly the case for non-financial assets for which valuation techniques and level 2 and 3 inputs are required.</td>
</tr>
</tbody>
</table>
### SECTION SUMMARY

SFRS(I) 13 defines fair value, establishes a framework for measuring fair value and sets out disclosure requirements for fair values. The measurement of fair value assumes that an asset or liability changes hands in the principal or most advantageous market.
SFRS(I) Practice Statement: Making Materiality Judgements

Chapter Roundup
SFRS(I) 13 *Fair Value Measurement*

- **Fair value** = exit (selling) price

  - **Principal market or if no principal market, most advantageous market**
  - **Based on highest and best use for non-financial asset**
  - **Use valuation technique:**
    - Income approach
    - Market approach
    - Cost approach

- **Most advantageous market where selling price = transport costs = transaction costs maximised**

- **Fair value** is selling price – transport costs (ignore transaction costs)

- **Inputs to valuation technique:**
  - Level 1
  - Level 2
  - Level 3
Quick Quiz

1. Why is a conceptual framework necessary?
2. What are the disadvantages of a conceptual framework?
3. What are the fundamental qualitative characteristics of the Conceptual Framework?
4. What is the most common measurement basis applied to elements of the financial statements?
5. What are the advantages of current cost accounting?
6. How does SFRS(1) 13 relate to other SFRS(1)s?
Answers to Quick Quiz

1. To provide a theoretical basis for financial reporting.

2. (a) A single conceptual framework may not suit all users.
    (b) Different standards, based on a different framework, may be needed to meet the needs of different users.
    (c) It is not clear that a conceptual framework does in fact facilitate the preparation of financial statements.

3. Relevance and faithful representation

4. Historical cost

5. (a) It can be used to indicate whether the dividends paid to shareholders will reduce the operating capability of the business.
    (b) It is a useful guide for management in deciding whether to hold or sell assets.
    (c) It is relevant to the needs of information users in a number of ways.
    (d) It can be implemented fairly easily in practice.

6. In accordance with SFRS(I) 13:5, SFRS(I) 13 applies when another SFRS(I) requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements), except as specified in paragraphs 6 and 7. SFRS(I) 13:6 states that the measurement and disclosure requirements of the SFRS(I) do not apply to the following:
    (a) Share based payments within the scope of SFRS(I) 2 Share-based Payment
    (b) Leasing transactions accounted for in accordance with SFRS(I) 16 Leases
    (c) Measurements that have some similarities to fair value but are not fair value, such as net realisable value in SFRS(I) 1-2 Inventories or value in use in SFRS(I) 1-36 Impairment of Assets

Answer to Question

3.1 Assets and liabilities

(a) This is an asset, albeit an intangible one. There is a past event, control and future economic benefit (through cost savings).

(b) This cannot be classified as an asset. Semba Engineering has no control over the car repair shop and it is difficult to argue that there are ‘future economic benefits’.

(c) The warranty claims in total constitute a liability; the business has taken on an obligation. It would be recognised when the warranty is issued rather than when a claim is made.
You should be aware that not-for-profit entities and smaller entities may have different accounting needs from the larger profit-making entities that you are used to. This chapter gives you the background you need to set you thinking about whether a one-size-fits-all set of standards is adequate.

**Topic list**

1 Charities
2 Statutory Boards
3 The not-for-profit sector
4 Small companies
5 Cash basis of accounting
### Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Other Reporting Frameworks</strong></td>
<td></td>
</tr>
<tr>
<td>Demonstrate an understanding of other financial reporting frameworks such as SMEs, Statutory Boards, charities and cash basis of accounting.</td>
<td>2</td>
</tr>
<tr>
<td><strong>Objectives of Financial Reporting</strong></td>
<td></td>
</tr>
<tr>
<td>Identify and explain the different stakeholders’ roles in public sector financial reporting.</td>
<td>2</td>
</tr>
</tbody>
</table>

### 1 Charities

#### SECTION INTRODUCTION

Charities are not-for-profit non-government sector entities for which a specific reporting framework exists. A Charity Portal has been set up to help organisations set up and manage a charity as well as fund-raising issues. The Charity Portal can be accessed at www.charities.gov.sg.

#### 1.1 Charities

Charities can be defined as organisations that meet all the following criteria.

1. They operate on a not-for-profit basis.
2. They are set up for charitable purposes, which includes any of the following:
   1. Relief of poverty
   2. Advancement of education
   3. Advancement of religion
   4. Other purposes beneficial to the community such as promotion of health, advancement of citizenship, or community development, advancement of arts, heritage or science, advancement of environmental protection or improvement, relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage, advancement of animal welfare, advancement of sport where the sport promotes health through physical skill and exertion.
3. They carry out activities to achieve the above purposes which benefit the public.

However, a distinction should be made between a charity and an Institution of a Public Character.

#### 1.2 Institution of a Public Character

An Institution of a Public Character (IPC) is a charity which is authorised to receive tax-deductible donations and is obligated to issue tax deduction receipts to the donors. The donors making qualifying donations to an IPC will be able to claim tax relief against their income. This makes donations to IPCs more attractive to donors.

As a result, IPCs are required to have higher standards in both regulatory compliance as well as governance.
The activities of an IPC must be beneficial to the community in Singapore as a whole. It should not be limited to sectional interest or any particular group of persons based on race, creed, belief or religion, unless it has been approved by the Minister.

1.3 Registration as a charity or an IPC

Under the Charities (Registration of Charities) Regulations, organisations will have to comply with the following conditions to be registered as charities or IPCs.

- Purposes or objects of the organisation must be exclusively charitable;
- Organisation must have at least three governing board members, of whom at least two must be Singapore citizens or permanent residents; and
- Purposes or objects of the organisation must be beneficial wholly or substantially to the community in Singapore.

In addition to the above, the charity or IPC should be a legal entity set up as one of the following:

- Society under the Registry of Societies (ROS)
- Company Limited by Guarantee (CLG) under the Accounting and Corporate Regulatory Authority (ACRA)
- Trust under the Office of Commissioner of Charities (COC)

1.4 Fundraising

The main source of income for charities and IPCs to support their operations is through fundraising. Charities and IPCs may carry out fundraising activities themselves or other entities may wish to raise funds for a charity or IPC or commercial fundraisers may be engaged to appeal for donations. In any case, all accounting records relating to fundraising activities must be maintained for a minimum of five years from the end of the financial year. In addition, charities and IPCs must disclose in their consolidated financial statements the consolidated amounts of donations received from the fundraising activities.

1.4.1 The 30/70 fundraising efficiency ratio

Fundraising expenses should not exceed 30% of the total funds raised. This is the 30/70 fundraising efficiency ratio, or commonly known as the 30/70 rule. The rule states that:

1. Gross receipts shall exclude trading activities with the intention to make profits in order to fund the charitable causes
2. Sponsorship shall include cash sponsorships and in-kind sponsorships

Formula for 30/70 Rule

\[
\frac{E + S}{R + S} \times 100\% < 30\%
\]

where:

‘E’ refers to the total expenses relating to fundraising for the financial year, including:

- Direct and material indirect expenses of any kind; and
- Payments made to commercial fundraisers engaged by the charity/IPC, but excluding, in a case of the sale of goods by or on behalf of the charity/IPC for fundraising (and not trading), the cost of the goods sold.
‘R’ refers to:
- The total receipts from such sale (after excluding only the cost of the goods sold), in the case of sale of goods by or on behalf of the charity or IPC for fundraising (and not trading); and
- The total gross receipts from any other fund-raising for that financial year.

‘S’ refers to:
- Total amount of sponsorships in cash received by the charity or IPC relating to fundraising for that financial year, conditional upon the provision of direct or indirect commercial benefit to the sponsors; and
- Total cost or value of sponsored property, goods and services for which tax deduction receipts are issued relating to fundraising for that financial year (this applies to IPCs only).

Example:

An IPC conducted a charity run to raise funds for cancer patients. The funds raised were $200,000 while the direct fund-raising expenses such as cost of venue, hydration drinks and event management were $35,000.

\[
\frac{E}{R} = \frac{35,000}{200,000} = 17.5\%
\]

The efficiency ratio would be 17.5%, and meets the 30/70 rule.

1.5 Annual submission

Currently, all IPCs need to have their accounts externally audited. All charities are required to have their accounts audited under the Charities (Accounts and Annual Report) Regulations and to comply with either Financial Reporting Standards (FRS, which are similar to SFRS(I)) or the simpler Charities Accounting Standard (CAS). The following are the audit thresholds applicable to charity accounts:

<table>
<thead>
<tr>
<th>Income/Expenditure</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>$250k or less</td>
<td>Accounts can be examined by an independent person (also known as the independent examiner) whom the governing board members believe have the relevant ability and practical experience.</td>
</tr>
<tr>
<td>Between $250k and $500k</td>
<td>Accounts can be examined by an independent person who is a member of the Institute of Singapore Chartered Accountants (formerly known as the Institute of Certified Public Accountants of Singapore), or who possesses the necessary qualifications to be a member of the Institute of Singapore Chartered Accountants.</td>
</tr>
<tr>
<td>Above $500k</td>
<td>Accounts have to be externally audited by a public accountant.</td>
</tr>
</tbody>
</table>

Charities and IPCs are required to submit, within six months after the year-end, their Annual Report including a statement of accounts and a Governance Evaluation Checklist to the Commissioner of Charities or Sector Administrators.

In June 2011, the Singapore Accounting Standards Council (ASC) issued a new Charities Accounting Standard (CAS). CAS was developed with the objective of providing charities with an alternative financial reporting framework to FRS that is simpler and more relevant to the charity sector.

As a result of its issue, charities may apply either full FRS or the Charities Accounting Standard (CAS) as follows:
- All charities that are registered under the Charities Act with significant investments in any subsidiary, associate or joint venture that is not a charity must use FRS.
• All other charities (including those registered as companies under the *Companies Act*, large IPCs without significant non-charity investments) may use FRS or the CAS.
• The CAS is not applicable to charities that are either government funded educational institutions or statutory bodies scheduled in the Charities (Accounts and Annual Report) Regulation 2011 and *Accounting Standards Act* respectively.

1.5.1 Statement of Accounts

CAS is a simpler form of financial reporting framework that is specific to charities. The standard provides simplified accounting rules, in relation to full FRS, as follows:

(a) The statement of profit or loss and other comprehensive income and statement of changes in equity are replaced by a statement of financial activities.
(b) A third statement of financial position is not required where retrospective adjustment has occurred.
(c) All borrowing and development costs are expensed immediately.
(d) There is no revaluation model available for property, plant and equipment or intangible assets and no fair value option for investment properties.
(e) Intangible assets are assigned a finite useful life not exceeding ten years.

These simplified requirements are in many cases identical to the simplified requirements of the SFRS for Small Entities, which we discuss in detail later in this Textbook.

1.5.2 Statement of Financial Activities

The Statement of Financial Activities (SOFA) is the primary statement showing the results of the charity's activities for the period.

The SOFA shows *Incoming resources*, *Resources expended*, and the resultant net movement in funds.

Under *Incoming resources*, income from all sources of funds are listed. These can include:

• Subscription or membership fees
• Public donations
• Donations from patrons
• Government grants
• Income from sale of goods
• Investment income
• Publication sales
• Royalties

The resources expended will show the amount spent directly in furtherance of the charity's objects. It will also show items which form part of any statement of profit or loss and other comprehensive income, such as salaries, depreciation, travelling, audit and other professional fees. As already identified earlier, the fundraising expenses of IPCs should not exceed 30% of the total funds raised according to the 30/70 rule.

Charities, especially the larger charities, now operate very much in the way that profit-making entities do. They run high-profile campaigns which cost money and they employ professional people who have to be paid. At the same time, their stakeholders will want to see that most of their donation is not going on running the business, rather than achieving the aims for which funds were donated.

One of the problems charities experience is that, even though the accruals basis is being applied, they will still have income and expenditure recognised in different periods, due to the difficulty of correlating them. The extreme example is a campaign to persuade people to leave money to the charity in their will. The costs will have to be recognised, but there is no way to predict when the income will arise.
1.5.3 Governance Evaluation Checklist

The Governance Evaluation Checklist (GEC) is a self-evaluation checklist designed to assess if a charity or IPC has complied with the essential principles and practices in the Code of Governance for Charities and IPCs (The Code). The Code, which was first introduced in November 2007 and refined in 2011, adopts the principle of ‘comply or explain’ which allows flexibility for charities and IPCs to comply to areas that are relevant and explain the areas that may not be relevant. This allows the public to understand the circumstances facing the charities and IPCs.

As charities and IPCs vary in size, activity and circumstances, the Code provides a tiered guideline depending on the IPC status and size of the charity as follows:

(a) Basic I Tier is applicable to charities with gross annual receipts of less than $50,000.
(b) Basic II Tier is applicable to charities with gross annual receipts of $50,000 and up to $10 million; and IPCs with gross annual receipts of less than $200,000.
(c) Enhanced Tier is applicable to large charities with gross annual receipts of $10 million or more; and IPCs with gross annual receipts of $200,000 and up to $10 million.
(d) Advanced Tier is applicable to large IPCs with gross annual receipts of $10 million or more.

For IPCs, an additional return on the tax deductible donations received in the preceding calendar year has to be made by 31 January.

1.6 Performance measurement

While charities must demonstrate that they have made proper use of whatever funds they have received, their stakeholders will be more interested in what they have achieved in terms of their stated mission. For instance, people who donate money to a relief fund for earthquake victims will want to know what help has been given to survivors, before enquiring how well the organisation has managed its funds. Although it must be said that any mismanagement of funds by a charity is taken very seriously by the donating public.

Some charities produce ‘impact reports’ which highlight what the charity set out to achieve, what it has achieved and what it has yet to do. Stakeholders should know what the organisation is aiming to achieve and how it is succeeding. Each charity will have its own performance indicators which enable it to measure this.

Suggested Reading

Candidates are encouraged to review the major headings within the Charities Accounting Standard.

Question 4.1

Choose a charity with which you are familiar and produce a possible set of key performance indicators (KPI) for it.

SECTION SUMMARY

A Charities Accounting Standard (CAS) has been issued in Singapore to provide simplified accounting guidance for charities.
2 Statutory Boards

SECTION INTRODUCTION

Statutory Boards have different stakeholders and objectives from companies and therefore separate accounting standards are required.

Statutory Boards are autonomous organisations that have been given power to perform an operational function by the Singapore Government. Unlike companies, they are set up to fulfil public functions, are not profit driven and do not have public shareholders.

Each Statutory Board is managed by a Board of Directors appointed by the responsible Minister. The Board is headed by a Chairman and consists of representatives from related ministries, professional bodies and interest groups from the private sector.

Some Statutory Boards, such as the Tote Board and the Civil Aviation Authority of Singapore (CAAS) are able to generate sufficient revenues to cover recurring operating expenditure and generate a surplus. Others, particularly those providing social services such as the Institute of Technical Education (ITE) receive subsidies or grants from the government to help finance their activities. Some Statutory Boards are almost entirely dependent on the government for their funding as they receive limited revenues eg the Singapore Tourism Board.

The stakeholders of a Statutory Board, together with their objectives are:

(a) **Government Ministers** need to know that Statutory Boards are fulfilling their remit. Where deficits are funded or all funding is provided, Ministers also need to know that costs are under control and therefore funding is not excessive.

(b) **The general public** are concerned with the role that a Statutory Board fills and how successful it is at meeting its objectives. The general public also want to know that Statutory Boards do not benefit from excessive incomes at a cost to the public (indirectly through taxes or directly through revenue generation).

(c) **Suppliers and lenders** are concerned with payments of obligations.

(d) **Customers** are concerned with competitive pricing (where relevant), quality and level of service.

2.1 Need for separate accounting standards for Statutory Boards

As a result of these different aims, some Singapore FRS are not applicable to Statutory Boards, and equally there is no FRS to cover certain areas which are applicable. It is therefore necessary to have a separate set of accounting standards.

Statutory Boards are required to present an annual report to Parliament annually which includes financial statements prepared in accordance with these standards.

2.2 Framework for SB-FRS

In Singapore, the Accountant-General has had the legal authority to prescribe accounting standards for Statutory Boards since 2007. Such accounting standards are known as Statutory Board Financial Reporting Standards (SB-FRS) and can be found at www.assb.gov.sg/fr-assb_frs.html

Guidance notes accompany the SB-FRS.
FRS are the key guiding framework for SB-FRS, however each FRS is individually considered and modifications are made or additional guidelines issued, where necessary, to address the specific needs of Statutory Boards.

Each SB-FRS bears the same number as the corresponding FRS (and is related to the corresponding SFRS(I) as described in Chapter 1), and the SB-FRS currently in issue are:

- Preface: Preface to Statutory Board Financial Reporting Standards
- SB-FRS 1: Presentation of Financial Statements
- SB-FRS 2: Inventories
- SB-FRS 7: Statement of Cash Flows
- SB-FRS 8: Accounting Policies, Changes in Accounting Estimates and Errors
- SB-FRS 10: Events after the Reporting Period
- SB-FRS 11: Construction Contracts
- SB-FRS 12: Income Taxes
- SB-FRS 16: Property, Plant and Equipment
- SB-FRS 17: Leases
- SB-FRS 19: Employee Benefits
- SB-FRS 20: Accounting for Government Grants and Disclosure of Government Assistance
- SB-FRS 21: The Effects of Changes in Foreign Exchange Rates
- SB-FRS 23: Borrowing Costs
- SB-FRS 24: Related Party Disclosures
- SB-FRS 26: Accounting and Reporting by Retirement Benefit Plans
- SB-FRS 27: Separate Financial Statements
- SB-FRS 28: Investments in Associates and Joint Ventures
- SB-FRS 29: Financial Reporting in Hyperinflationary Economies
- SB-FRS 32: Financial Instruments: Presentation
- SB-FRS 33: Earnings Per Share
- SB-FRS 34: Interim Financial Reporting
- SB-FRS 36: Impairment of Assets
- SB-FRS 37: Provisions, Contingent Liabilities and Contingent Assets
- SB-FRS 38: Intangible Assets
- SB-FRS 39: Financial Instruments: Recognition and Measurement
- SB-FRS 40: Investment Property
- SB-FRS 41: Agriculture
- SB-FRS 101: First-time Adoption of Financial Reporting Standards
- SB-FRS 102: Share-based Payment
- SB-FRS 103: Business Combinations
- SB-FRS 104: Insurance Contracts
2.3 Process of adopting standards issued by the ASC

The process for adopting standards issued by the ASC is described on that part of the Singapore Government’s website that deals with accounting standards for statutory boards at www.assb.gov.sg/fr-assb_process.html

When the ASC issues an ED, the Advisory Committee on Accounting Standards for Statutory Boards issues an equivalent ED in parallel. Depending on the nature of the issues dealt with in the ED and the level of complexity, the Advisory Committee may also conduct further research or consult with academics or accountancy firms.

After the ASC issues a final standard, the Advisory Committee considers any changes from the earlier ED together with comments from Statutory Boards and decides whether to adopt the FRS, and if so whether modifications are necessary. Where modifications are made, explanation of these is provided together with the revised standard.

2.4 Performance measurement

Statutory Boards will have performance measures laid down by government. The emphasis is on economy, efficiency and effectiveness. They must show how they have spent public money and what level of service they have achieved. Performance measurement will be based on Key Performance Indicators (KPIs).

Examples of these could be:

(a) Growth in offshore trade for International Enterprise Singapore
(b) Percentage of immunisation coverage for two-year olds for the Health Promotion Board
(c) Length of rail and number of stations added on the Mass Rapid Transport system for the Land Transport Authority

SECTION SUMMARY

Statutory Boards’ main stakeholders are the Government Ministers to whom they report and the general public. They must prepare financial statements for public disclosure annually in accordance with SB-FRS which are modified versions of full FRS.
3 The not-for-profit sector

SECTION INTRODUCTION

Not all entities have profit as their main objective. In this section, the reporting frameworks for not-for-profit entities such as Public Sector Entities, will be explored.

What organisations do we have in mind when we refer to not-for-profit entities? These are the most obvious examples:

- Statutory Boards such as Central Provident Fund Board (CPF)
- Government Departments such as the Accountant-General's Department (AGD)
- Further and higher education institutions such as the Singapore Institute of Management (SIM)
- Charitable bodies such as Children's Cancer Foundation

Not-for-profit entities have different goals and purposes to profit-making entities and are responsible to different stakeholders. However, they are often dealing in very large sums of money and it is important that they are properly managed and that their accounts present fairly the results of their operations.

Characteristics of not-for-profit entities have been identified by the IASB's ‘Report on the Application to Not-for-profit Entities in the Private and Public Sectors in Appendix A’ as follows:

Non-government sector not-for-profit entities have the following characteristics:

(a) Their objective is to provide goods and services to various recipients and not to make a profit.
(b) They are generally characterised by the absence of defined ownership interests (shares) that can be sold, transferred or redeemed.
(c) They may have a wide group of stakeholders to consider (including the public at large in some cases).
(d) Their revenues generally arise from contributions (donations or membership dues) rather than sales.
(e) Their capital assets are typically acquired and held to deliver services without the intention of earning a return on them.

Government sector not-for-profit entities have similar key characteristics to those in the non-government sectors. They are typically established by legislation and:

(a) Their objective is to provide goods and services to various recipients or to develop or implement policy on behalf of governments and not to make a profit.
(b) They are characterised by the absence of defined ownership interests that can be sold, transferred or redeemed.
(c) They typically have a wide group of stakeholders to consider (including the public at large).
(d) Their revenues are generally derived from taxes or other similar contributions obtained through the exercise of coercive powers.
(e) Their capital assets are typically acquired and held to deliver services without the intention of earning a return on them.

3.1 Accountability/stewardship

Not-for-profit entities are not reporting to shareholders, but it is very important that they can account for funds received and show how they have been spent. In some cases, resources may be contributed for
specific purposes and management is required to show that they have been utilised for that purpose. Perhaps most importantly, in respect of public sector organisations, taxpayers are entitled to see how the government is spending their money.

3.2 Users and user groups

The primary user group for not-for-profit entities is providers of funds. In the case of public bodies, such as government departments, this primary group will consist of taxpayers. In the case of private bodies such as charities it will be financial supporters, and also potential future financial supporters. There is also a case for saying that a second primary user group should be recognised, being the recipients of the goods and services provided by the not-for-profit entity.

3.3 Financial reporting

Not-for-profit entities need to generate cash flows, but other aspects are generally more significant – for instance, the resources the entity has available to deliver future goods and services, the cost and effectiveness of those it has delivered in the past and the degree to which it is meeting its objectives.

The International Public Sector Accounting Standards (IPSAS) Board issues accounting standards applicable to public sector entities. These standards are based on IFRS. In 2016 the Trustees of the IFRS Foundation concluded a review of the structure and effectiveness of the organisation which included consideration of whether the IASB should extend its remit to address the financial reporting of not-for-profit organisations. The Foundation concluded that the existing focus on for-profit entities would be retained.

3.4 Budgeting

Like profit-seeking sector entities, budgets and variances analysis are important to the not-for-profit sector entities. For government-funded not-for-profit entities, budgets serve as a guide to make efficient use of limited resources. For instance, zero-based budgeting which is recommended for government sectors as decisions are made by grouping projects into decision packages and ranking them with the highest priority to be carried out first.

For charities who rely solely on donations to fund their operations, budgets are important tools to ensure sustainability and efficient use of limited resources.

Next, budgets are compared to actual results to identify areas of improvements and necessary actions are taken.

SECTION SUMMARY

The not-for-profit sector includes public sector entities and private not-for-profit entities such as charities.

Not-for-profit entities have different goals from profit making entities, but they still need to be properly managed and their accounts need to present the information fairly.
4 Small companies

SECTION INTRODUCTION

Most companies are small and full FRS and SFRS(I) are not relevant to their needs.

In Singapore, like most countries, the majority of companies or other types of entity are very small, and often owner-managed. In other words there are no outside shareholders to protect.

The Accounting Standards Council (ASC) in its Singapore Financial Reporting Standard for Small Entities (SFRS for Small Entities) has stated that ‘an entity qualifies as a small entity in respect of a financial reporting period if it meets at least two of the three following criteria:

| Total annual revenue ≤ S$10m | Total gross assets ≤ S$10m | Total number of employees ≤ 50 |

This kind of ownership structure is in contrast to that of companies listed on a stock exchange such as the SGX. Shareholders of listed companies need protection and the regulations for such companies need to be more stringent.

It could therefore be argued that company accounts are of two types:

1. ‘Simple’ ones for small companies with fewer regulations and disclosure requirements
2. ‘More detailed’ ones for larger companies with extensive and in-depth requirements

This issue is generally viewed as having two solutions:

1. A separate accounting standard for smaller companies
2. A system whereby parts of accounting standards are not applicable to smaller companies

Singapore has adopted the former solution and issued the SFRS for Small Entities in 2010. This standard simplifies the accounting requirements of full FRS and SFRS(I). It is covered in detail in Chapter 23 of this Textbook, after the requirements of SFRS(I) have been explained.

SECTION SUMMARY

An accounting standard specifically for small entities has been issued: the SFRS for Small Entities.

5 Cash basis of accounting

SECTION INTRODUCTION

Companies are required to present their financial statements on an accruals basis according to FRS and SFRS(I)s.
The cash basis and the accruals basis of accounting are the two primary methods of recognising income and expenditure in accounting.

The *Conceptual Framework*, FRSs and SFRS(I)s require the use of the accruals basis of accounting in all financial statements other than the statement of cash flows and therefore the majority of this Textbook concentrates on the accruals basis.

### 5.1 What is the cash basis?

The cash basis of accounting involves recording revenue when cash is received and recording expenses when cash is paid. Therefore amounts invoiced to customers do not appear as revenue until received and amounts invoiced by suppliers do not appear as costs until paid.

This is in contrast with the accruals basis of accounting where income is recognised when earned, regardless of whether cash is received, and expenses are recognised when incurred, regardless of whether cash is paid.

The Statement of Cash Flows is used within accruals based financial statements in order to highlight that the rest of the statements are not prepared on a cash basis.

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**SECTION SUMMARY**

Cash basis accounting involves recognising revenue when cash is received and expenses when cash is paid. It is a simple form of accounting which may be relevant to very small cash based businesses. For other unincorporated businesses, however, adopting the cash basis may result in mis-management of funds as it is difficult to gain an understanding of financial position and performance.
Chapter Roundup

Other reporting frameworks

- Charities
  - Registration as charity or IPC
  - Statement of Accounts
    - FRS
    - CAS
    - SB-FRS

- Statutory Boards
  - Power given by Singapore government
  - Present annual report to Parliament

- Not for profit
  - Characteristics

- Small companies
  - Definition

- Cash basis of accounting
  - Not allowed in Singapore
  - SFRS for Small Entities
Quick Quiz

1. All charities can issue tax deduction receipts to donors. True or false?
2. Why do not-for-profit entities need to keep accounts if they are not reporting to shareholders?
3. Are there any special accounting standards for the public sector in Singapore?
4. What accounting framework must large IPCs use in Singapore?
Answers to Quick Quiz

1. False. Only IPCs can issue tax deduction receipts to donors.
2. They are often entrusted with monies from stakeholders such as donors for specific charitable purposes. The requirement to keep accounts would provide a certain level of transparency and accountability.
4. CAS or FRS unless the large IPC holds significant investments in any subsidiary, associate or joint venture that is not a charity in which case it is required to comply with the full FRSs.

Answer to Question

4.1 Performance indicators

Possible set of performance indicators for a charity.

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<thead>
<tr>
<th>Financial KPIs</th>
<th>Non-financial KPIs</th>
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<tr>
<td>• Funds raised compared with target</td>
<td>• Number of tax deduction receipts issued on-time</td>
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<td>• Expenses incurred in relation to funds raised (a</td>
<td>• Trustworthiness and reputation of charity or IPC as</td>
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<td>good KPI would be to adhere to the 30/70 rule)</td>
<td>indicated by donors willingness to donate and IPC</td>
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<td>• Allocation of funds per patient (or per school,</td>
<td>status</td>
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<td>per family)</td>
<td>• Ability of charity and IPC to meet the set</td>
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<td>• Degree of governance complied with and</td>
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PART B
Professional Ethics
in Financial Reporting
There is a temptation to think of professional ethics as a topic that relates only to assurance providers, rather than preparers of financial statements. It is easy to place excess reliance on the assurance opinions of internal and external audit as a way of seeming to endorse the ethics of preparers of financial statements.

The existence of an audit function does not relieve the preparer of financial statements of the need to present unbiased financial statements that give as accurate and unbiased a picture of the entity's performance and position as possible. In addition, auditors are likely to work within constraints of materiality, knowing less about the detail than the preparer of accounts does.

Ethics are of at least as great a significance at the preparation of financial statements stage as in the audit of those financial statements and must pervade every judgment made by preparers of financial statements.

**Topic list**

1. Fundamental ethical principles and EP 100
2. The benefits of ethics in corporate reporting
3. Ethical frameworks and human behaviour
4. Dealing with ethical conflict
Syllabus Handbook

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<td>Assess the relevance and importance of ethical and professional issues in</td>
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<td>complying with accounting standards.</td>
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<td>Appraise the potential ethical implications of professional and managerial</td>
<td>3</td>
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<td>decisions in the preparation of financial reports.</td>
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<td>Appraise, discuss and recommend an appropriate course of action arising from</td>
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<td>ethical dilemmas in financial reporting.</td>
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<tr>
<td>Assess the consequences of not upholding ethical principles in the preparation</td>
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<td>of financial reports.</td>
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**ESSENTIAL READING**

Ethics Pronouncement (EP) 100 (2018), Code of Corporate Governance

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1 Fundamental ethical principles and EP 100

**SECTION INTRODUCTION**

Chartered Accountants have the responsibility to act in the public interest. To do this, a Chartered Accountant must observe fundamental ethical principles: integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

Ethics can be broadly defined as the morally accepted behaviour and the ability to determine right or wrong for a given situation. To become a Chartered Accountant in Singapore, a member must adhere to Ethics Pronouncement (EP) 100 Code of Professional Conduct and Ethics issued by ISCA (the ISCA Code). A revised Code was issued in November 2015 and became effective on 1 January 2016. Further updates were issued on 14 August 2018 which are expected to become effective on 15 December 2018. In addition, there are likely to be workplace employee handbooks on ethical behaviour, resolving conflicts of interest, employee conduct and policies for dealing with people and certain workplace situations.

Chartered accountants are required to exhibit professional behaviour when conducting all work. If we are always mindful of fundamental ethical principles and continue to ask ourselves if all of our actions and decisions are in accordance with the spirit of these rules, it is very likely that we will behave in a suitably professional and ethical manner.

Although you may have seen these fundamental principles a number of times before, they are the bedrock of all that we do. It is impossible, therefore, to overstate their importance and relevance to our everyday work.

1.1 Public's expectation of accountants

The public and community have certain expectations of accountants such as the following:

- To prepare reliable financial statements of the company
- To ensure the financial statements comply with existing rules and regulations
- To serve their employers
- To maintain relevance and public trust
- To warn the directors of unacceptable practices

Although there may be an expectation gap, a Chartered Accountant must regularly revisit EP 100 to ensure professional ethical conduct.

1.2 EP 100

*Ethics Pronouncement (EP) 100* as revised in 2015 is effective from 1 January 2016 and supersedes ISCA’s previous Code of Professional Conduct and Ethics. Further revisions took place in August 2018 which are expected to be effective from December 2018. It requires a professional accountant to comply with five fundamental principles

**IMPORTANT**

**Integrity.** A member should be straightforward and honest in all professional and business relationships.

**Objectivity.** A member should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

**Professional competence and due care.** A member has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

**Confidentiality.** A member should respect the confidentiality of information acquired as a result of professional and business relationships and should therefore not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

**Professional behaviour.** A member should comply with relevant laws and regulations and should avoid any action that discredits the profession.


1.2.1 Threats to compliance with the fundamental principles

There are five general sources of threat identified within EP 100:

1. **Self-interest** threat (for example, having a financial interest in a client)
2. **Self-review** threat (for example, auditing financial statements prepared by the audit firm)
3. **Advocacy** threat (for example, promoting shares in a listed entity when that entity is an audit client)
4. **Familiarity** threat (for example, an audit team where the audit partner has a long association with the client)
5. **Intimidation** threat (for example, threats of auditor replacement due to disagreement as well as workplace bullying)
In the scenarios below, what are the threats to objectivity? How serious are they? What actions should the affected parties take to mitigate the risks to independence?

1. The CFO holds a large number of shares in the listed company that the CFO works for. Currently the CFO needs to authorise an appropriate figure for the company's allowance for doubtful debts and has been provided with a range of four estimates by members of the finance team.

2. The in-house head of the tax planning team has been asked to advise the board on what figure should be incorporated in the financial statements for current tax payable.

3. The valuation of certain over-the-counter derivatives is performed by the financial controller using a spreadsheet that the financial controller has developed. It is notoriously complicated and the model used has never been updated by any other person.

4. The company's performance for the current year is looking to be rather embarrassingly below estimates that were given to investors when the company was floated on the Singapore Exchange two years ago.

5. The board of directors of a large company consists entirely of non-accountants. In practice, the board takes the recommendations of the CFO on all finance matters. The CFO has come to implicitly trust the advice of the chief accountant. The CFO will only ever sign any documents if the chief accountant initials a sticky note on each document with the words ‘OK to sign’.

6. The company is being sued for trade defamation by a rival. It was recently notified of the legal claim by lawyers acting for the other side, though the dispute is in its early stages. The dispute arose from a joke the CEO made at a recent trade conference. The company says that it will contest the case, which the CEO describes as ‘silly, attention seeking and just a publicity stunt’.

1.2.2 Professional accountants in business

As well as establishing the fundamental principles of ethics for professional accountants and providing a conceptual framework for applying these, EP 100 as issued in 2018 includes guidance on the application of this conceptual framework:

- Part B of EP 100 illustrates its application by professional accountants in public practice (this is within your Assurance syllabus)
- Part C of EP 100 illustrates its application by professional accountants in business

Professional accountants in business may be jointly or solely responsible for preparing financial reports which other parties rely on, and for providing effective financial management. Such an accountant is expected not only to comply with the fundamental principles him or herself, but also encourage an ethics-based organisational culture that emphasises the importance that management place on ethics. EP 100 addresses the application of ethics to five areas of behaviour in particular:

Conflicts of interest

Accountants in business may face a conflict of interest, for example, when serving in a managerial or governance position for two employers. When addressing such a conflict of interest, a professional accountant in business should seek guidance from his or her employer(s) or from other parties such as professional bodies. Safeguards should be applied to reduce the threat to an acceptable level and if this is not possible, the accountant should discontinue the activity that results in the conflict of interest.

Preparation and reporting of information

A professional accountant should prepare and report information that others may rely on fairly, honestly and in accordance with professional standards – SFRS(I)s in the case of financial statements. Any threat
to compliance with the fundamental ethical principles, resulting in the preparation of misleading information, should be evaluated and safeguards applied to reduce the threat to an acceptable level. If this is not possible, the professional accountant should take steps to be disassociated with the misleading information. The accountant may also consider reporting the circumstances outside the organisation.

**Acting with sufficient expertise**

A professional accountant in business should only undertake tasks for which he or she already has, or can obtain, sufficient specific training and experience. The accountant should not mislead employers intentionally as to their level of expertise or experience. Threats such as inadequate resources for the performance of duties or insufficient time to complete duties may exist; if these cannot be reduced to an acceptable level, the accountant should consider whether he or she refuses to perform the duties in question.

**Financial interests, compensation and incentives linked to financial reporting and decision making**

A self-interest threat may exist, for example, where a professional accountant in business is eligible for a bonus that is related to financial information that he or she prepares. Where this type of self-interest threat arising from compensation arrangements exists, the accountant must not manipulate information for personal gain (or the gain of others). Safeguards to this type of threat include the existence of a remuneration committee and internal and external audit procedures.

**Inducements**

Inducements including gifts, hospitality or preferential treatment may be offered to a professional accountant in business or their family members. If an inducement is offered, the situation should be evaluated; if a reasonable and informed third party would conclude that the inducement is insignificant and not intended to encourage unethical behaviour, then it can be concluded that there is no threat to compliance with the fundamental principles. Otherwise safeguards should be applied to reduce the threat to an acceptable level, and if this is not possible, the inducement should not be accepted. In addition, since the offering of the inducement itself may be interpreted as a threat to compliance, the accountant may be required to inform higher levels of management or governing or professional bodies of the inducement.

### 1.3 ISCA Ethics Centre

**WEBSITE**

ISCA launched an Ethics Centre as part of thought leadership initiatives, to raise awareness of integrity and ethics as well as to discuss current ethical issues. The Ethics Centre can be accessed at [http://isca.org.sg/ethics/](http://isca.org.sg/ethics/).

The objectives of the Ethics Centre are:

- Raising awareness of *EP 100*
- Providing practical guidance and case studies to members from different perspectives
- Showcasing the news on local accounting and auditing failure or fraud cases
- Providing a platform for members (and subscribers) in raising and discussing practical ethical issues faced via online forum
- Providing a platform feedback on the Ethics Centre
- Providing members with an Ethics virtual learning centre

Candidates are encouraged to visit the Ethics Centre and review *EP 100 (2018)*. There are also useful frequently asked questions, case studies on practical ethical issues as well as local accounting and auditing failure and fraud cases.
1.4 Code of Corporate Governance

WEBSITE

The Monetary Authority of Singapore (MAS) issued the Revised Code of Corporate Governance in August 2018:

The Code of Corporate Governance covers the following 13 principles:

**Principle 1 The Board’s Conduct of Affairs**
Every company should be headed by an effective Board which is collectively responsible and works with the Management for the long-term success of the company.

**Principle 2 Board Composition and Guidance**
There should be an appropriate level of independence and diversity of thought and background in the composition of the Board to enable it to make decisions in the best interests of the company.

**Principle 3 Chairman and Chief Executive Officer**
There should be a clear division of responsibilities between the leadership of the Board and the Management, and no one individual should have unfettered powers of decision-making.

**Principle 4 Board Membership**
There should be a formal and transparent process for the appointment and reappointment of directors to the Board, taking into account the need for progressive renewal of the Board.

**Principle 5 Board Performance**
There should be a formal annual assessment of the effectiveness of the Board as a whole and each of its board committees and individual directors.

**Principle 6 Procedures for developing Remuneration Policies**
There should be a formal and transparent procedure for developing policies on director and executive remuneration and for fixing the remuneration packages of individual directors and key management personnel. No director should be involved in deciding their own remuneration.

**Principle 7 Level and Mix of Remuneration**
The level and structure of remuneration of the Board and key management personnel should be appropriate and proportionate to the sustained performance and value creation of the company, taking into account the strategic objectives of the company.

**Principle 8 Disclosure on Remuneration**
Every company should be transparent on its remuneration policies, level and mix of remuneration, the procedure for setting remuneration and the relationships between remuneration, performance and value creation.

**Principle 9 Risk Management and Internal Controls**
The Board is responsible for the governance of risk and should ensure that Management maintains a sound system of risk management and internal controls to safeguard the interests of the company and its shareholders.

**Principle 10 Audit Committee**
The Board should have an Audit Committee (AC) which discharges its duties objectively.
Principle 11 Shareholder Rights and Conduct of General Meetings
Companies should treat all shareholders fairly and equitably, in order to enable them to exercise shareholders’ rights, and have the opportunity to communicate their views on matters affecting the company. The company should give shareholders a balanced and understandable assessment of its performance, position and prospects.

Principle 12 Engagement with Shareholders
Companies should communicate regularly with their shareholders and facilitate the participation of shareholders during general meetings and other dialogues to allow shareholders to communicate their views on various matters affecting the company.

Principle 13 Engagement with Stakeholders
The Board should adopt an inclusive approach by considering and balancing the needs and interests of material stakeholders as part of its overall responsibility to ensure that the best interests of the company are served.

1.5 Can an internal accountant ever be objective?
Objectivity is one of the fundamental principles in the EP 100 and a member should not allow bias, conflict of interest or the undue influence of others to compromise professional or business judgments (120.1). An internal accountant should be as objective as possible, but it is likely that over time, objectivity may become compromised as familiarity grows.

Safeguards will need to be in place to guard against errors arising from growing threats to objectivity. These safeguards might include:
(a) Peer review of work, especially where estimates are involved
(b) Review by more senior staff
(c) Internal audit scrutiny of key systems and figures in the financial statements before they are released to stakeholders
(d) Rotation of responsibilities within the finance team, in order to bring a fresh viewpoint to accounting systems and the making of estimates in particular
(e) Estimates might be made using a consensus average of a number of estimates created by different team members, independently of each other

2 The benefits of ethics in corporate reporting

SECTION INTRODUCTION
Investor confidence is increased if the company acts ethically in its financial reporting.

The reputation of an organisation reflects society's perception of the financial, environmental, and social values of that entity over time. Factors that contribute to an entity's reputation include organisational culture, corporate strategy, the calibre of management and employees, the quality of the product/service and internal control. It is important that a company makes ethical decisions as this will affect investor confidence in the truthfulness and completeness of information that management provide to them.

Quality decision making and investor confidence both require complete and accurate financial record keeping and financial reporting.
### Reputation
This is the view that other people have of the business. A strong reputation will contribute positively to the share price and thus to shareholders' wealth.

### Fairness
This is a neutral attitude between stakeholders, having respect for rights and views of any other group with a legitimate interest.

### Integrity
Honesty, fair dealing and truthfulness (International Federation of Accountants definition); high moral character. Where management are perceived as having high integrity, stakeholders are likely to be more confident that the information provided is truthful and unbiased.

### Judgment
Judgment means making the right decisions that will maximise the organisation's wealth by using evidence to support decision making and to reach good decisions.

### Independence/objectivity
Objectivity is a state of mind that considers all matters relevant to a decision and disregards all matters that are not relevant. It implies detachment, lack of bias, not influenced by personal feelings, prejudices or emotions or fear of consequences of a decision.

### Honesty/probity
Probity means truthfulness and not misleading people. It is linked to openness.

### Openness/transparency
This is a default assumption that full and complete disclosure of all matters that a stakeholder would be interested to know is best. Sometimes, the best interests of stakeholders are best served by keeping information comparatively private, as it would be of excessive benefit to competitors. This should be the exception rather than the rule.

### Responsibility
A director showing responsibility is one who is 'taking ownership' of a problem in order to solve it.
Accountability

This is an acceptance that it is correct to be answerable for the consequences of decisions and actions. The legal duty to prepare accounts for shareholders is an obvious example of accountability, but it also includes speedy and open responses to legitimate requests for information and criticism.

Real life case studies

There have been a number of global scandals that have damaged investor confidence in the free market system. Although some of these undoubtedly involved poor business strategy, a common feature is also bias or deliberate fraud in the preparation of financial statements.

CASE STUDY

Summary case study: Lehman Brothers (2008)

On 15 September 2008, Lehman Brothers (the Bank) filed for Chapter 11 bankruptcy protection. It is the largest bankruptcy case in the United States (US) and the bankruptcy came after repeated assurances from the company. From 2004 to 2007, the Bank was a major mortgage loan provider during the US housing boom, contributing to the creation of a housing bubble, with its share price reaching a record high of $86.18 per share. However, the housing bubble started to show signs of bursting in early 2007 when the demand for housing slowed down tremendously and home-owners were unable to repay their mortgages. At this point, it was of little use for the bank to seize the mortgaged property for resale, since the entire housing market had excess supply of properties which would fetch minimum returns. Instead of taking prudent actions, Lehman Brothers continued to provide mortgage-backed securities and ignored deteriorating domestic and global market conditions.

In order to cover its losses, the Bank implemented Repo 105 for the first six months in 2008 to help create favourable and positive debt and liquidity. Repo 105 is the sale of assets and the subsequent repurchase of the same assets at 105% of the cash received. These transactions are legally accepted by US Generally Accepted Accounting Principles (GAAP) to be recognised as sales, due to the profit above the cash received. Lehman Brothers created a phantom company Hudson Castle, which was controlled by the executives, and raised cash by selling assets (loan receivables and mortgaged securities) to it, and repurchasing them between one and three days later. The Bank recognised sales and cash received, thus removing assets from the Bank's statement of financial position. This helped to improve its revenue by $100 billion and reversed its leverage ratio from a worrying 13.9 to a more favourable 12.1. The financial statements would now show healthy revenue and high liquidity from the fictitious sales. The auditors, Ernst & Young, failed to reveal and alert either internal or external parties to the arrangement.

The collapse of Lehman Brothers in 2008 is widely seen as the trigger to the global financial crisis.

There is considerable evidence that the management of Lehman Brothers had been engaging in the manipulation of the organisation's financial statements by selling illiquid assets shortly before each quarter end. These assets were then purchased back from the connected party shortly after the quarter end. In addition, Lehman Brothers packaged its 'bad debts' as complex financial instruments known as mini-bonds and sold them around the world. Upon its bankruptcy, these turned into toxic mini-bonds. Local banks and financial institutions in Singapore were punished by the Monetary Authority of Singapore (MAS) for not understanding the instruments they were selling.
The sale of mini-bonds was expensive and probably a sign of desperation. As a bank, it was necessary for the financial statements of Lehman Brothers to demonstrate a certain level of solvency and liquidity. The statement of financial position at each date that regulatory reporting was required appeared to meet the solvency and liquidity requirements, but in reality it was extremely unrepresentative of the company’s underlying financial health.

The company had engaged in practices that were designed entirely to make the financial statements appear in a certain way. This is a reversal of the objectives of financial reporting. The financial statements should present an unbiased picture of a company’s financial performance, arising from natural transactions from their line of business. Instead, in the case of Lehman Brothers, questionable transactions had been concocted in order to massage the figures.

This failure of ethics in corporate reporting looked certain to eventually be discovered. When it was, it triggered a catastrophic failure that came alarmingly close to precipitating a global collapse of the banking system.

Further reading

1. *The Dearth of Ethics and the Death of Lehman Brothers, Seven Pillars Institute*

2. *Lehman Brothers Minibond saga, 19 March 2010, National Library Board Singapore*

3. *Investigation Report on the Sale and Marketing of Structured Notes linked to Lehman Brothers, 7 July 2009, Monetary Authority of Singapore*
CASE STUDY

Summary case study: Enron (2001)

Enron's collapse in 2001 is now slipping into the mists of history, but it remains a good example of how a failure in business ethics can initially give great returns, but subsequently result in catastrophic collapse. This collapse caused huge losses to all stakeholders, including staff and former employees, whose pension had been, very unwisely, heavily invested in Enron's shares (possibly to support the company's vulnerable share price).

Enron was a Houston based energy company founded in 1985 by the merger of two gas pipeline companies. By 2000, Enron's revenue had reached $100 billion. It had transformed from a small energy company into a financial and energy trading company – trading financial derivatives, including weather derivatives, in 1997 through EnronOnline, an internet-based trading platform.

In 2001, Enron lost $1.2 billion in a failed hedging deal and resorted to selling 55 million shares to pay for the losses. A severe lack of transparency in its financial statements and hidden liabilities meant that no one knew about this until it was too late. The management of Enron had been involved in money laundering securities, insider trading, fraud and conspiracy to inflate Enron's profits.

By Quarter 3 2001, Moody's and Standard and Poor's (S&P) downgraded Enron to junk bond status. Finally, on 2 December 2001, having once been the seventh largest US company, Enron filed for bankruptcy. In 2002, Enron restated its financial statements by reducing profits for 2001 by $600 million and $591 million for profits between 1997 and 2000. The company also increased its debts by $628 million. This prompted the US Securities and Exchange Commission (SEC) to investigate Enron's audit work, performed by Arthur Andersen, formerly one of the Big 5. It found that the financial statements were fraudulent. On 31 August 2002, the audit firm agreed to surrender its licenses and its right to practice to the SEC. This effectively put Arthur Andersen out of business.

The collapse of Enron not only led to the demise of a global Big 5 audit firm, but it also brought about the Sarbanes–Oxley Act of 2002 to address corporate governance.

In summary, Enron's business strategy had been very high risk and probably fundamentally flawed. The company depended heavily on non-recurring events, like asset sales, to achieve the target annual growth of 15%. Its financial affairs became very complicated, but a feature was that a number of heavily indebted 'toxic' entities that were controlled by Enron were not consolidated into the financial statements. This would almost certainly have been impossible under Singapore FRS, SFRS(I) or IFRS, but appears to have followed the letter, if not the spirit, of US GAAP as it applied at the time.

It appears that transactions were structured in such a way that the preparers of the financial statements could comply with the legal form of the accounting law yet fail to provide information about the commercial substance of transactions that would have been highly relevant to investors.

This type of deliberate misrepresentation of the truth is fraud and it resulted in huge losses to many investors. Rightly, it also resulted in the lack of ethical behaviour being punished by severe criminal sanctions for some of the surviving perpetrators.

Further reading

1. One Year Later, The Impact of Sarbanes-Oxley, 22 July 2003, Forbes
2. Enron scandal at-a-glance, 22 August 2002, BBC
   http://news.bbc.co.uk/2/hi/business/1780075.stm
2.1 Managing investor expectations

In a free capital market, listed companies will have a share price that moves minute-by-minute. For a share price to be reasonably efficient (i.e., be suitably linked to the fundamental performance of the company, its future profit and dividends) it will occasionally be necessary for management to step in to manage investor expectations.

Directors of companies listed on the Singapore Exchange are required to announce price sensitive information to the market and to intervene with corrective information where it appears that the share price is entering a speculative bubble. This is because speculative bubbles eventually burst, causing losses to people who bought shares at the wrong time. Price correction mechanisms may include:

- Interim reports, such as a quarterly summary or half-year report
- All price sensitive information including profit warnings

There is a substantial difference both ethically and practically between managing reasonable shareholder expectations, such as outlined above and ‘spin’, which manages the message.

For example, if a listed entity has suffered an impairment loss on property during a period, it will recognise a large non-cash expense in profit. Legitimate managing of expectations would be to indicate to investors, via the Stock Exchange, that performance in the coming year is likely to be below many investors’ current expectations. However, seeming to belittle the expense as ‘simply a non-cash item’ or similar comments that might undermine the accounting rule itself are not legitimate.

Directors need to be careful in the wording chosen in the Management Commentary issued with financial statements that their words do not place an unjustifiable spin on figures that have been presented in compliance with SFRS(I).

3 Ethical frameworks and human behaviour

While attempts have been made to codify ethical behaviour, personal values and beliefs also shape an individual’s approach to ethical issues.

In certain situations, there may be multiple courses of action that would give resolutions to ethical conflict that most people would accept as appropriate. Equally, it is likely that some courses of action would not be considered by the majority of an entity’s stakeholders to be a satisfactory resolution to an ethical dilemma.

It is important when resolving ethical conflict to consider questions such as:

(a) How would I feel if my decisions and reasoning that brought me to my conclusion were to be made public? This is sometimes referred to as the sunlight test. Another way to think about ethical decision-making is to consider whether you would be happy if your decision made front page news in the Straits Times.

(b) Are there any cultural issues that might suggest that stakeholders would see this situation as more serious than I believe it to be?

(c) Are my views influenced for better or for worse by the people around me who naturally exert considerable influence over me?

3.1 Corporate culture and authoritarianism

People with greater experience and age have a vast amount to contribute to all business decisions, including what figures are appropriate in the financial statements.

Just as familiarity with a business increases efficiency but also produces a familiarity threat to independence, however, it is possible that time can make even the most competent people rather less open to scrutiny and challenge. The level of power that is exercised by a CEO or CFO can make it
especially difficult to suggest that they may have overlooked matters or have formed a regrettable judgment.

We should all familiarise ourselves with whatever controls our employers have to allow for proper reporting of concerns that we might have about the judgments of our superiors. There is a delicate balance here between undermining legitimate authority but not allowing ourselves to be swept along in a culture that can produce dysfunctional results for our stakeholders.

**CASE STUDY**

**Summary case study: Korean Airlines**

It may be helpful to look briefly at another profession to see how it has learned to strike an appropriate balance between raising questions about competence and judgment of superiors, without undermining legitimate authority and certainty of who is in charge.

Historically the senior pilots of a number of Asian airlines have made wrong decisions, but not being challenged by other more junior staff, who felt that something was wrong. This is especially notable in Korean Airlines, which had an unacceptably high number of crashes due to senior pilot error that junior staff did not feel able to point out or challenge.

After a period in which the reputation of the airline was damaged by excessive numbers of incidents, Korean Airlines undertook extensive retraining of all of its crews to ensure that all staff felt able to politely question decisions where they felt a more senior member of the crew may have omitted some factor that should be considered. This was encouraged and all staff were instructed to disregard any feelings of ‘loss of face’ as not relevant when making safety decisions. Pilots from different cultures were brought into the airline’s teams to reinforce the cultural mix.

Since embarking upon this cultural retraining and policy of safety and ethics first above respect for experience and authority, the company’s safety record has improved from being one of the worst in the world to being one of the best.  
(adapted from *Outliers: The Story of Success* by Malcolm Gladwell)

As a Chartered Accountant of Singapore, it is likely that you may find yourself being the senior member of your team at different times in your career. It is incumbent upon you to ensure that all staff in your team are able to politely question you or make helpful suggestions. Proportionate, polite and fair response to legitimate criticism is something that all professionals should be able to give and encourage.

### 4 Dealing with ethical conflict

**Ethical conflict resolution**

Resolution of ethical conflict is something that we must all do. Throughout your career, you will be presented with situations where it is not immediately obvious what the correct course of action should be.

Both in practice and in exams, an appropriate approach is set out below.
Determine all the relevant facts of the situation. Without all the facts, appropriate judgment is impossible. For example, what are the company's policies and procedures that might be relevant?

Who are the relevant parties? Identify all affected stakeholders and prioritise the validity of their claims using a suitable, fair methodology.

What are the ethical issues involved? Are there ways in which the ethical guidance pulls you in opposite directions in this scenario? What are the cultural norms involved, both nationally and within the company? Does the company have any specific guidance on this area?

What are the fundamental ethical principles involved (eg integrity, objectivity)? What are the apparent threats and are there any professional guidance statements that might be of use?

What are all the alternatives that might be helpful in this scenario?

Of the alternatives in step 5, which seem to provide the best fit with professional ethical guidance, your own ethical principles, the policies of the company and the legitimate claims of each stakeholder?

What is your conclusion? Give reasons for your conclusion.

4.1 Whistleblowing

Accountants have access to financial information as well as corporate matters and are often in a good position to become a whistleblower to raise concerns about the organisation's wrongdoing, malpractice or risks. The accountant has assumed the role as the gatekeeper of the company to prevent corporate failures and scandals.

When there is evidence of wrongdoings, the accountant, being an employee, should first refer to the company's policy and procedure on whistleblowing, if it exists. Otherwise, discuss the matter internally through appropriate channels and make reference to EP 100 as a member of a professional body. A good independent body to approach should be the company's Chairman or AC before going public with the information of wrongdoing. Amongst the considerations, the accountant should consider personal risk, danger and apply the above seven steps to identify the ethical issues involved.

The following is an example of a company's policy and procedure on whistleblowing extracted from Singapore Press Holding (SPH) www.sph.com.sg/corporate-governance/whistleblowing-policy-procedure/
Whistleblowing Policy & Procedure

Purpose & Scope

The SPH Group does not tolerate any malpractice, impropriety, statutory non-compliance or wrongdoing by staff in the course of their work. This Whistleblowing Policy (the ‘Policy’) is intended to provide a framework to promote responsible and secure whistleblowing without fear of adverse consequences.

Employees and outside parties, such as suppliers, customers, contractors and other stakeholders, may use the procedures set out in the Policy to report any concern or complaint regarding questionable accounting or auditing matters, internal controls, disclosure matters, conflict of interest, insider trading, collusion with competitors, serious breaches of Group policy, unsafe work practices or any other matters involving fraud, corruption and employee misconduct.

The Policy allows for reporting by employees or outside parties of such matters to the Internal Audit Division of the Group, without fear of reprisal, discrimination or adverse consequences, and also permits the Group to address such reports by taking appropriate action, including, but not limited to, disciplining or terminating the employment and/or services of those responsible.

This Policy is meant to protect genuine whistleblowers from any unfair treatment as a result of their report. Frivolous and bogus complaints will be disregarded. The Policy is also not a route for taking up personal grievances. These should continue to be taken up directly with Division or Department heads.

Reporting Mechanisms

The Group encourages employees and outside parties to put their names to their allegations whenever possible. Concerns or irregularities expressed anonymously are more difficult to act upon effectively but they will be considered, taking into account the seriousness and credibility of the issues raised, and the likelihood of confirming the allegation from attributable sources and information provided. All concerns or irregularities raised will be treated with confidence and every effort will be made to ensure that confidentiality is maintained throughout the process.

Concerns may be raised verbally or in writing. As it is essential for the Group to have all critical information in order to be able to effectively evaluate and investigate a complaint, the report made should provide as much detail and be as specific as possible. The complaint should include details of the parties involved, dates or period of time, the type of concern, evidence substantiating the complaint, where possible, and contact details, in case further information is required. The Receiving Officer is Head, Internal Audit Division. The contact details of the Receiving Officer are as follows:

Address: News Centre, Annex Block, Level 11, Internal Audit Division
Hotline: 6319-6007
Email: whistleblow@sph.com.sg

Complaints raised to other parties within the Group will be directed to the Receiving Officer, who is responsible for maintaining a centralized repository of all reported cases and ensuring that issues raised are properly resolved. All matters reported will be reviewed within a reasonable timeframe, and after due consideration and inquiry, a decision will be taken on whether to proceed with a detailed investigation. Guidance/direction may be sought from the CEO and other appropriate parties.

The Receiving Officer submits whistleblowing complaints alleging irregularities to the CEO. Feedback on operational matters are forwarded to the respective division/department heads for their follow-up. Complaints involving allegations of fraud and breaches of corporate governance will be submitted to the Chairman of the Board of SPH. In addition, where the complaints relate to a senior executive and/or the CEO, the Receiving Officer will escalate these to the Chairman of the Board who will then decide whether to report the matter to the Board.

All complaints received by the Receiving Officer are submitted to the Audit Committee for information.

The whistleblower email and hotline are for reporting irregularities such as:

1. Forgery
2. Misappropriation of funds and classified documents
Abuse and misrepresentation of power and authority
Failure to comply with laws and regulations
Discrimination on the basis of gender, race, disabilities
Harassment
Corruption and bribery
Theft

If you have any feedback on our editorial processes or news articles, please go to http://sph.com.sg/contact-us/for-media/media-contacts/
If you would like to give feedback on other aspects of the Group’s operations, please go to http://sph.com.sg/contact-us/feedback/
You can also visit the ‘Contact Us’ tag found on the Group’s corporate website www.sph.com.sg to give your feedback to the relevant departments.

Safeguards
The Group prohibits discrimination, retaliation or harassment of any kind against a whistleblower who submits a complaint or report in good faith. If a whistleblower believes that he or she is being subjected to discrimination, retaliation or harassment for having made a report under this Policy, he or she should immediately report those facts to the CEO. Reporting should be done promptly to facilitate investigation and the taking of appropriate action.

At the appropriate time, the party making the report/complaint may need to come forward as a witness. If an employee or outside party makes an allegation in good faith but it is not confirmed by the investigation, no action will be taken against him or her. If, however, an employee has made an allegation frivolously, maliciously or for personal gain, disciplinary action may be taken against him or her. Likewise, if investigations reveal that the outside party making the complaint had done so maliciously or for personal gain, appropriate action, including reporting the matter to the police, may be taken.

Handling of Complaints
The Receiving Officer may, in consultation with the CEO and/or senior management, direct the complaint to the division/department best placed to address it, or lead the investigation to ensure prompt and appropriate investigation and resolution. All information disclosed during the course of investigation will remain confidential, except as necessary or appropriate to conduct the investigation and to take any remedial action, in accordance with any applicable laws and regulations.

The Group reserves the right to refer any concerns or complaints to appropriate external regulatory authorities. Depending on the nature of the complaint, the subject of the complaint may be informed of the allegations against him or her and be provided with an opportunity to reply to such allegations. Employees who fail to cooperate in an investigation, or deliberately provide false information during an investigation, shall be subject to strict disciplinary action up to, and including, immediate dismissal.

If, at the conclusion of an investigation, the Group determines that a violation has occurred or the allegations are substantiated, effective remedial action commensurate with the severity of the offence will be taken.

Modification
The Group may modify this Policy to maintain compliance with applicable laws and regulations or accommodate organisational changes within the Group.

4.2 Workplace ethics and fairness
As a fresh graduate and undergoing the Singapore CA Qualification programme, a trainee accountant may experience ethical dilemmas, conflict of interests and workplace pressures. This section aims to address the practical side of workplace ethics.
A few common conflicts at the trainee accountant level may include:

### 4.2.1 Preparing accounting records and financial statements

The audit client has the responsibility to prepare financial statements in compliance with accounting standards and regulations. The audit firm should not assist the client to prepare financial statements by determining journal entries, authorising transactions or preparing source documents and subsequently auditing them.

### 4.2.2 Time pressure

A competent professional accountant should only undertake significant tasks which they have obtained sufficient training or previous experience. Otherwise, it may affect the ability of delivery of duties. Common causes include:

- Insufficient time for properly performing or completing the relevant duties
- Incomplete, restricted or otherwise inadequate information for performing the duties properly
- Insufficient experience, training and/or education
- Inadequate resources for the proper performance of the duties

When the above situation arises, the trainee accountant should consider:

- Obtaining additional advice or training
- Ensuring that there is adequate time available for performing the relevant duties
- Obtaining assistance from someone with the necessary expertise
- Consulting, where appropriate, with:
  - Superiors within the employing organisation
  - Independent experts
  - A relevant professional body

If the above cannot be resolved, the trainee accountant should consider whether to refuse to perform the duties.

### 4.2.3 Receiving offers

There may be situations where the trainee accountant may encounter offers of inducements in various forms such as gifts, holidays, hospitality, preferential treatment and inappropriate appeals to friendship or loyalty. The following are suggested actions:

(a) Where such offers have been made, immediately inform higher levels of management or those charged with governance of the employing organisation.

(b) Inform third parties of the offer – for example, a professional body or the employer of the individual who made the offer; a professional accountant in business should, however, consider seeking legal advice before taking such a step.

(c) Advise immediate or close family members of relevant threats and safeguards where they are potentially in positions that might result in offers of inducements, for example as a result of their employment situation.

(d) Inform higher levels of management or those charged with governance of the employing organisation where immediate or close family members are employed by competitors or potential suppliers of that organisation.
Chapter Roundup

Ethics

Fundamental principles
- Integrity
- Objectivity
- Professional
- Competence and due care
- Confidentiality
- Professional behaviour

Benefits
- Quality decision making
- Investor confidence

Frameworks
- Personal values
- Corporate culture

Ethical conflict
- Seven-step approach
  - Whistleblowing

Threats:
- Self-interest
- Self-review
- Advocacy
- Familiarity
- Intimidation
Quick Quiz

1. What is the definition of integrity according to *Ethics Pronouncement (EP) 100*?

2. What are the fundamental ethical principles of *EP 100* issued by the Institute of Singapore Chartered Accountants?

3. List the threats to compliance with the fundamental ethical principles.
Answers to Quick Quiz

1. ‘A professional accountant should be straightforward and honest in all professional and business relationships.’ *(EP 100)*

2. Integrity, objectivity, professional competence and due care, confidentiality and professional behaviour

3. Self-interest threat, self-review threat, advocacy threat, familiarity threat, intimidation threat

Answer to Question

5.1 Scenarios

**Scenario 1**

This scenario gives a self-interest threat. The CFO has shares, which are likely to fall in value if a higher-than-expected allowance for doubtful debts is recorded. The severity of the threat depends on the materiality of the range of reasonable estimates for doubtful debts.

It is likely that the best mitigation is to have peer review of the figure or a consensus figure, which appears to be the practice here. Using a consensus opinion allows for self-review threats to be diminished. Of course, the attesting to the truth and fairness of the financial statements by the external auditor is the last line of defence in this inherent conflict of interests.

**Scenario 2**

This probably gives rise to self-review and familiarity threats to objectivity. One of the roles of the tax planning team would be to minimise tax payments for the company. It is possible that the head of tax-planning may be overly-aggressive in attempting to do so. As a professional, however the individual should ensure that he/she is acting within the law and the board should ensure that it promotes a culture which increases the likelihood that this will be the case.

Seeking a concurring opinion from another tax advisor is probably the best way to mitigate the risk, as would be adjusting the figure suggested by the head of the tax planning team for differences between previous estimates and amounts eventually settled with the IRAS (or foreign tax authority).

**Scenario 3**

This scenario probably gives rise to a self-review threat to objectivity. The calculations appear to be complex and are derived from a model put together by the person who is responsible for making a recommendation to the board that the financial statements are suitable for issue.

A suitable control would be to have other point estimates determined by other staff, using models that they have developed themselves. Given the complexity of the transactions, this might be an expensive task, but the inherent risk of misstatement is high and so there is a fairly strong business case for this additional expenditure.

**Scenario 4**

This might be seen as giving rise to an intimidation threat to objectivity, as well as a self-interest threat. Both would be derived from the fact that the directors might feel some loss of face from announcing disappointing results. This is likely to give rise to bias (both conscious and subconscious) that is likely to result in estimates favouring overstatement of true profit.

This is potentially a severe threat to independence. The role of an audit committee and the external auditor would be important here.
Scenario 5

There appears a risk here of a familiarity threat to objectivity. The CFO, as director, is probably primarily responsible for the preparation and filing of the accounts, but this task appears to be delegated almost entirely to the chief accountant. There appears to be little scrutiny of the figures recommended for approval by the chief accountant. As such, self-review threat to work done by the chief accountant also exists.

This weakness in governance is very serious, as it could result at any time in accidental material errors. Where documents are of significant importance the CFO should carry out suitable checks for himself/herself prior to signing them.

Scenario 6

There is no evidence that the CEO is legally competent to assess the probable risk to the company, nor magnitude of any damages and costs of any legal defence.

In addition to this ethical issue of questionable competence, there is probably an advocacy threat to objectivity from the CEO.

The company should deal with this ethical threat by obtaining legal advice and trying to settle the dispute amicably at the earliest convenience.
PART C
Presentation of
Financial Statements
In this chapter we revise the requirements of SFRS(I) 1-1 *Presentation of Financial Statements*, considering the format and contents of financial statements. We also meet SFRS(I) 1-8 *Accounting Policies, Changes in Accounting Estimates and Errors* and introduce SFRS(I) 1-21 *The Effects of Changes in Foreign Exchange Rates* which is relevant to all Singapore companies which conduct any trade in a currency other than the Singapore dollar.
### Syllabus Handbook

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<th>Cognitive level</th>
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<td><strong>Equity and Other Comprehensive Income</strong></td>
<td></td>
</tr>
<tr>
<td>Apply the accounting, disclosure and presentation requirements for equity and other comprehensive income components.</td>
<td>3</td>
</tr>
<tr>
<td><strong>The Conceptual Framework for Financial Reporting</strong></td>
<td></td>
</tr>
<tr>
<td>Apply the principles of the framework to recommend an accounting treatment for a transaction not covered by an extant accounting standard or a proposed new standard.</td>
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<tr>
<td><strong>Foreign Currency Transactions</strong></td>
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<td>Apply and explain the rules for determination of an entity's functional currency.</td>
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<tr>
<td>Apply the rules for recording and reporting foreign currency transactions for a single entity, other than for hedging transactions.</td>
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### ESSENTIAL READING


### 1 Financial statements

#### SECTION INTRODUCTION

SFRS(I) 1-1 *Presentation of Financial Statements* sets out the overall requirements for financial statements, including how they should be structured, minimum requirements for content and overriding concepts such as going concern and the accruals basis of accounting.

You have seen SFRS(I) 1-1 *Presentation of Financial Statements* in your previous studies, and should be familiar with the format of the main financial statements.

The objective of SFRS(I) 1-1 is to prescribe the basis for the presentation of general purpose financial statements to ensure comparability with the financial statements of previous periods and those of other entities. The standard sets out:

- Overall requirements for the presentation of general purpose financial statements
- Guidelines for their structure
- Minimum content requirements
1.1 A complete set of financial statements

SFRS(I) 1-1 states that a complete set of financial statements includes the following:

(a) A statement of financial position as at the end of the period
(b) A statement of profit or loss and other comprehensive income for the period
(c) A statement of changes in equity for the period
(d) A statement of cash flows for the period
(e) Notes, comprising a summary of significant accounting policies and other explanatory information
(f) Comparative information in respect of the preceding period
(g) A statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements in accordance with paragraphs 40A-40D

The financial statements must be clearly identified and distinguished from other information in the same published document.

With the exception of the statement of cash flows and related notes, all information in the financial statements must be prepared using the accrual basis of accounting.

The statement of cash flows is dealt with later in this Textbook; the statements of financial position, profit or loss and other comprehensive income and changes in equity are considered in more detail in the following sections of this chapter.

Note entities are free to choose the title of the various statements. For example, statement of comprehensive income may be used instead of statement of profit or loss and other comprehensive income.

1.1.1 Frequency of reporting

A complete set of financial statements (including comparative information) must be presented at least annually (Companies Act s201). Where a company reports for a period shorter or longer than 12 months, it must disclose the reason for using a shorter or longer period and the fact that amounts presented in the financial statements are not entirely comparable. The maximum reporting period permitted is 18 months after the company is first incorporated, and then a period of no longer than 15 months after that.

1.1.2 Comparative information

Comparative information must be presented in respect of the preceding period for all amounts reported in the financial statements other than where another SFRS(I) allows or requires otherwise. Therefore, as a minimum, two of each of the statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity, statement of cash flows and notes to the accounts are required.

1.1.3 Consistency of presentation

The presentation and classification of items in the financial statements must be consistent from one period to the next unless:

(a) It is apparent that another presentation or classification would be more appropriate (for example where the disposal of a significant part of a business has taken place); or
(b) An SFRS(I) requires a change in presentation.

Where the presentation or classification of items in the financial statements is changed, comparative information must also be reclassified unless this is impracticable. Where this is impracticable, the reason for not reclassifying amounts is disclosed, and the nature of the adjustments that would have been made if the amounts had been reclassified.
SECTION SUMMARY

A complete set of financial statements includes:

- A statement of financial position as at the end of the period
- A statement of profit or loss and other comprehensive income for the period
- A statement of changes in equity for the period
- A statement of cash flows for the period
- Notes to the financial statements

The above must be presented for the current period and comparative period. Where retrospective adjustment has taken place a third statement of financial position at the beginning of the comparative period is required.

2 Statement of financial position

SECTION INTRODUCTION

SFRS(I) 1-1 prescribes the format of the statement of financial position and its minimum content.

SFRS(I) 1-1 sets out a format for the statement of financial position in the Implementation Guidance (IG). You should review the example provided in the IG.

There is no requirement to present the statement of financial position in the layout set out in the IG and it is common in Singapore to list share capital, reserves and long term borrowings first as one 'half' of the statement of financial position, and then non-current assets, current assets and current liabilities as the second 'half'.

2.1 Minimum disclosure

SFRS(I) 1-1 (paragraph 54) requires that the statement of financial position includes the following line items, if they are material:

(a) Property, plant and equipment
(b) Investment property
(c) Intangible assets
(d) Financial assets (excluding amounts shown under (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 in accordance with SFRS(I) 5 Non-current Assets Held for Sale and Discontinued Operations
(k) Trade and other payables
(l) Provisions
(m) Financial liabilities (excluding amounts shown under (k) and (l))
(n) Liabilities and assets for current tax, as defined in SFRS(I) 1-12 Income Taxes
(o) Deferred tax liabilities and deferred tax assets, as defined in SFRS(I) 1-12 Income Taxes
(p) Liabilities included in disposal groups classified as held for sale in accordance with SFRS(I) 5 Non-current Assets Held for Sale and Discontinued Operations
(q) Non-controlling interests, presented within equity
(r) Issued capital and reserves attributable to owners of the parent

Line items may be aggregated if they are immaterial. Additional line items (due to disaggregating the minimum disclosure line items listed above), headings and subtotals should be presented when they are relevant to an understanding of an entity's financial position.

2.1.2 Subtotals
Subtotals should:
(a) Contain only line items made up of amounts recognised and measured in accordance with other SFRS(I)s;
(b) Be presented and labelled in such a way that the subtotal is clear and understandable;
(c) Be consistent from one period to the next (in accordance with SFRS(I) 1-1 paragraph 45); and
(d) Not be given more prominence than subtotals and totals required by SFRS(I)s.

2.2 Current/Non-current classification
SFRS(I) 1-1 (paragraph 60) requires that current and non-current assets and liabilities are presented separately in the statement of financial position, unless a presentation based on liquidity is reliable and more relevant. In this case assets and liabilities are presented in order of liquidity. A presentation in order of liquidity is often more appropriate for financial institutions because they do not supply goods or services within a clearly identifiable operating cycle. When a presentation in order of liquidity is used, information on amounts expected to be recovered or settled in less than 12 months after the reporting period and more than 12 months after the reporting period should be disclosed in the notes.

An asset or liability is current when:
(a) The asset is intended to be realised (or liability settled) within the normal operating cycle of the entity
(b) The asset or liability is held primarily for trading
(c) The asset is expected to be realised (or liability settled) within 12 months after the reporting period, or
(d) The asset is cash or a cash equivalent (as defined in SFRS(I) 1-7) unless the asset is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period
(e) There is no unconditional right to defer settlement of a liability for at least 12 months after the reporting period

A long-term financial liability due to be settled within 12 months of the year-end date should be classified as a current liability, even if an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorised for issue.

A long-term financial liability that is payable on demand because the entity breached a condition of its loan agreement should be classified as current at the year-end even if the lender has agreed after the year-end, and before the financial statements are authorised for issue, not to demand payment as a consequence of the breach.
However, if the lender has agreed by the year-end to provide a period of grace, ending at least 12 months after the year-end, within which the entity can rectify the breach and during that time the lender cannot demand immediate repayment, the liability is classified as non-current.

SECTION SUMMARY

As a minimum SFRS(I) 1-1 requires the main categories of asset and liability to be disclosed separately in the statement of financial position. Assets and liabilities must be classified as current or non-current.

3 Statement of profit or loss and other comprehensive income

SECTION INTRODUCTION

SFRS(I) 1-1 prescribes alternative formats for the statement of profit or loss and other comprehensive income.

The statement of profit or loss and other comprehensive income may be presented either in a single statement or two statements:

1. A statement of profit or loss (SPL)
2. A statement of profit or loss and other comprehensive income (SPLOCI)

The statement of profit or loss may be presented with expenses analysed either by nature or function, whichever provides information that is reliable and more relevant.

SFRS(I) 1-1 sets out a format for the statement of profit or loss and other comprehensive income in the Implementation Guidance (IG). You should review the examples provided in the IG.

3.1 Minimum disclosure

SFRS(I) 1-1 states that the following totals should be presented in the statement of profit or loss and other comprehensive income:

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

3.1.1 Profit or loss section

In addition to items required by other SFRS(I)s, the profit or loss section should include line items that present the following amounts for the period:

- Revenue
- Finance costs
- Share of the profit or loss of associates and joint ventures accounted for using the equity method
- Tax expense
- A single amount for the total of discontinued operations

The following line items would also be included where relevant:

(a) Gains and losses arising from the derecognition of financial assets measured at amortised cost
(b) 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
Additional line items, headings and subtotals should also be presented when such presentation is relevant to an understanding of the entity’s financial performance.

### 3.1.2 Other comprehensive income section

SFRS(I) 1-1 requires that other comprehensive income arising from associates and joint ventures is presented separately from the rest of other comprehensive income.

Therefore, the other comprehensive income section presents the following line items:

(a) Items of other comprehensive income classified by nature and grouped into those that:
   (i) Will not be reclassified subsequently to profit or loss
   (ii) Will be reclassified subsequently to profit or loss when specific conditions are met.

(b) The share of the other comprehensive income of associates and joint ventures accounted for using the equity method, separated into the share of items that:
   (i) Will not be reclassified subsequently to profit or loss
   (ii) Will be reclassified subsequently to profit or loss when specific conditions are met.

Items of other comprehensive income that will not be reclassified to profit or loss include gains/losses on property revaluation, and remeasurements of defined benefit pension plans.

Items of other comprehensive income that may be reclassified to profit or loss include exchange differences on the translation of foreign operations, gains or losses on instruments used in a cash flow hedge and gains on losses on some financial assets.

### 3.1.3 Subtotals

The guidance on subtotals applicable to the statement of financial position (see section 2.1.2) is also applicable to the statement of profit or loss and other comprehensive income.

For any subtotals presented in the statement of profit or loss and other comprehensive income, the line items should be disclosed that reconcile those subtotals back to the line items required by SFRS(I)s.

### 3.1.4 Allocation of profit or loss and total comprehensive income

The following items must also be disclosed in the statement of profit or loss and other comprehensive income as allocations of profit or loss for the period:

(a) Profit or loss for the period attributable to:
   (i) Non-controlling interests
   (ii) Owners of the parent

(b) Total comprehensive income for the period attributable to:
   (i) Non-controlling interests
   (ii) Owners of the parent

### SECTION SUMMARY

The statement of profit or loss and other comprehensive income may be shown in either one or two statements. Other comprehensive income is classified according to whether it may or may not be reclassified to profit or loss in the future.
4 Statement of changes in equity

SECTION INTRODUCTION

The statement of changes in equity reconciles shareholders’ funds at the start and end of the accounting period.

Shareholders' funds consist of ordinary share capital, revaluation reserve, retained earnings and any other components of equity.

The following should be disclosed within the statement of changes in equity:

(a) Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to the non-controlling interests

(b) For each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors

(c) For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from:

(i) Profit or loss;

(ii) Other comprehensive income; and

(iii) Transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners, and changes in ownership interests in subsidiaries that do not result in a loss of control.

An analysis of the other comprehensive income reported in the statement of changes in equity must be provided either within the statement of changes in equity itself, or in the notes to the accounts.

SFRS(I) 1-1 sets out a format for the statement of changes in equity in the Implementation Guidance (IG). You should review the example provided in the IG.

4.1 SFRS(I) INT 17 Distribution of Non-cash Assets to Owners

The statement of changes in equity, or the notes to it, includes amounts recognised as distributions to owners in the period. In most cases such a distribution is made in cash; SFRS(I) INT 17 deals with the situation where a distribution to owners is a non-cash asset. It only applies where:

- All owners of the same class of equity instruments are treated equally in a distribution; and
- The asset is controlled by a different party before and after the transfer.

4.1.1 Recognition of dividend payable

A liability to pay a dividend is recognised when the dividend is declared, unless approval is required (eg by shareholders), in which case it is recognised when the dividend is approved.

4.1.2 Measurement of dividend payable

A liability to distribute a non-cash asset as a dividend is measured at the fair value of asset to be distributed.

Where owners are given a choice of receiving cash or a non-cash asset, the dividend payable is estimated by considering the fair value of each alternative and the probability of the owners selecting each alternative.
Any liability recognised is reviewed and adjusted at the end of each reporting period with changes in the carrying amount recognised in equity as adjustments to the amount of the distribution.

When the entity settles the dividend payable, any difference between the carrying amount of the asset(s) distributed and the carrying amount of the dividend payable liability is recognised in profit or loss.

4.1.3 Disclosure

The carrying amount of a dividend payable at the start and end of the period should be disclosed, together with any increase or decrease in the carrying amount of the dividend payable as a result of changes in the fair value of assets to be distributed.

If an entity declares a distribution of a non-cash asset between the reporting date and the date on which the financial statements are authorised for issue, the following should be disclosed:

(a) The nature of the asset to be distributed;
(b) The carrying amount of the asset to be distributed at the end of the reporting period;
(c) The estimated fair value of the asset to be distributed as of the end of the reporting period, if different from the carrying amount; and
(d) Information about the method used to determine the fair value as required by SFRS(I) 13.

SECTION SUMMARY

The statement of changes in equity reconciles shareholders' funds at the start and end of the accounting period. Changes arising from profit or loss, other comprehensive income and transactions with owners in their capacity as owners must be disclosed separately.

5 Further requirements of SFRS(I) 1-1

SECTION INTRODUCTION

SFRS(I) 1-1 provides guidance on fair presentation, going concern, materiality, offsetting and disclosure notes.

As well as prescribing the format and content of financial statements, SFRS(I) 1-1 deals with:

- Fair presentation and compliance with SFRS(I)s
- Going concern
- Materiality and offsetting

5.1 Fair presentation

SFRS(I) 1-1 (paragraph 15) requires that the financial statements present fairly the financial position and performance of an entity. Guidance is provided on the meaning of present fairly, i.e., represent faithfully the effects of transactions and other events in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses as set out in the Conceptual Framework.

The application of SFRS(I)s, with additional disclosure where necessary, is presumed to result in financial statements that achieve a fair presentation.
5.1.1 Departure from SFRS(I)s

SFRS(I) 1-1 (paragraph 19) states that in **extremely rare circumstances**, where compliance with a requirement of an SFRS(I) may be so misleading that it would conflict with the objective of financial statements set out in the *Conceptual Framework*, the entity shall depart from that specific requirement. This is generally referred to as the true and fair override.

Departure from accounting standards is not allowed in certain countries of the world – the USA being a notable example. Other countries, including Singapore do allow the practice, however stipulate that its use is **extremely rare**.

Any entity which invokes the true and fair override must disclose:

(a) That management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows

(b) That it has complied with applicable SFRS(I)s except that it has departed from a particular requirement to achieve a fair presentation

(c) Full details of the departure

(d) The impact on the financial statements for each item affected and for each period presented

**Question 6.1**

Why should a company avoid departing from an SFRS(I) unless absolutely necessary to achieve fair presentation?

5.2 Going concern

SFRS(I) 1-1 requires financial statements to be prepared on a going concern basis unless the management of an entity intend to either liquidate the entity or cease trading, or have no realistic alternative but to do so. Any material uncertainties with regard to going concern should be disclosed.

Where financial statements are not prepared on a going concern basis, that fact must be stated together with the basis on which the financial statements were prepared and the reason why the entity is not considered to be a going concern.

5.3 Materiality, offsetting and aggregation

Within the financial statements SFRS(I) 1-1 requires that:

(a) Each material class of similar items is presented separately

(b) Items of a dissimilar nature are presented separately unless they are immaterial

(c) Assets and liabilities and income and expenditure are not offset unless this is required or permitted by another SFRS(I)

An entity may not obscure useful information by aggregating or disaggregating information. For example:

- Material items with different characteristics should not be aggregated
- Useful information should not be obscured with immaterial information

5.3.1 Materiality and disclosure

SFRS(I) 1-1 clarifies the interaction between materiality and disclosure:

(a) The materiality guidance in SFRS(I) 1-1 applies to the financial statements as a whole including the primary statements and notes.

(b) Disclosures are only required if information is material.
(c) This also applies even where a standard has specific disclosure requirements, even where those disclosures are required ‘as a minimum’.

(d) Additional disclosure may be required if the information specifically required by SFRS(I)s is insufficient to understand the impact of particular transactions, events or conditions.

### 5.4 Notes to the financial statements

The notes to the financial statements:

- **(a)** Present information about the basis of preparation of the financial statements and the specific accounting policies applied (see section 5.5);
- **(b)** Disclose the information required by SFRS(I)s that is not presented elsewhere; and
- **(c)** Provide information that is not presented elsewhere in the financial statements but is relevant to an understanding of any of them.

The understandability and comparability of the financial statements should be considered when determining a systematic approach to presenting notes. For example the structure of the notes may:

- **(a)** Give prominence to those notes that are most relevant to an understanding of financial position and performance by grouping together information about particular activities;
- **(b)** Group together notes relating to items measured in a similar way eg assets at fair value; or
- **(c)** Follow the order of the primary statements, eg:
  - **(i)** Statement of compliance with SFRS(I)
  - **(ii)** Significant accounting policies
  - **(iii)** Supporting information for items in the primary financial statements, in the order each item is presented
  - **(iv)** Other disclosures eg contingent liabilities

### 5.5 Additional disclosures

SFRS(I) 1-1 requires that an entity discloses the following in its financial statements:

- **(a)** The measurement bases used in preparing the financial statements
- **(b)** Other accounting policies that are relevant to an understanding of the financial statements
- **(c)** The judgments made by management in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements
- **(d)** Key assumptions about the future, and other sources of measurement uncertainty, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year
- **(e)** Information which enables users of the accounts to evaluate its objectives, policies and processes for managing capital

### SECTION SUMMARY

Fair presentation is assumed to be achieved when the requirements of SFRS(I) are followed. Departure from the requirements of an SFRS(I) is allowed, however only in very rare circumstances, in which case additional disclosure is required. In the financial statements, disclosure must be made of significant accounting policies, significant judgments, sources of estimation uncertainty and capital.
6 Accounting policies and estimates

SECTION INTRODUCTION

SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors deals with the selection of accounting policies, accounting for a change in an accounting policy, accounting for a change in an accounting estimate and accounting for an error.

SFRS(I) 1-8 is a standard that you are likely to have met before. Its objective is to prescribe:

- The criteria for selecting and changing accounting policies
- The accounting treatment and disclosure required:
  - Where accounting policies are changed
  - Where accounting estimates are changed
  - In respect of the correction of errors

6.1 Definitions

SFRS(I) 1-8 provides a number of definitions:

KEY TERMS

ACCOUNTING POLICIES are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

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

MATERIAL Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements.

PRIOR PERIOD ERRORS are omissions from, and misstatements in, the entity’s financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) Was available when financial statements for those periods were authorised for issue; and

(b) Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

RETROSPECTIVE APPLICATION is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

RETROSPECTIVE RESTATEMENT is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.
Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. It is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if one of the following apply.

(a) The effects of the retrospective application or retrospective restatement are not determinable.

(b) The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period.

(c) The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that: provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognised, measured or disclosed; and would have been available when the financial statements for that prior period were authorised for issue from other information.

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

(a) Applying the new accounting policy to transactions, other events and conditions occurring after the date at which the policy is changed; and

(b) Recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

6.2 Selection of accounting policies

Accounting policies are determined by applying the relevant SFRS(I) or interpretation and considering any relevant Implementation Guidance issued by the ASC for that standard.

Where there is no applicable accounting standard or interpretation, management should use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable. Management should refer to:

(a) The requirements and guidance in SFRS(I)s and interpretations dealing with similar and related issues

(b) The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Conceptual Framework

Management may also consider the most recent pronouncements of other standard setting bodies that use a similar conceptual framework to develop standards, other accounting literature and accepted industry practices if these do not conflict with the sources above.

6.3 Changes in accounting policies

An entity shall select and apply its accounting policies for a period consistently for similar transactions, other events and conditions, unless an SFRS(I) or an interpretation specifically requires or permits categorisation of items for which different policies may be appropriate. If an SFRS(I) or an interpretation requires or permits categorisation of items, an appropriate accounting policy shall be selected and applied consistently to each category.

Changes in accounting policies are rare and should only be made if:

- They are required by statute/standard-setting body; or
- The change results in reliable and more relevant information.
The following do not constitute changes in accounting policy:

(a) Adopting an accounting policy for a new type of transaction or event that is different from those previously occurring (ie a transaction not dealt with previously by the entity).

(b) Adopting a new accounting policy for a transaction or event which has not occurred in the past or which was not material.

In the case of non-current assets, if a policy of revaluation is adopted for the first time then this is a change in accounting policy, however the accounting treatment is provided in SFRS(I) 1-16 Property, Plant and Equipment and SFRS(I) 1-38 Intangible Assets rather than in SFRS(I) 1-8.

6.3.1 Accounting for a change in accounting policy

Where a change in accounting policy is the result of the initial application of an SFRS(I) that change should be accounted for in accordance with the specific transitional provisions, if any, in the SFRS(I).

Otherwise, a change in accounting policy should be applied retrospectively.

Retrospective application means that the new accounting policy is applied to transactions and events as if it had always been in use. In other words, the policy is applied from the earliest date such transactions or events occurred.

Where it is impracticable to apply a change in accounting policy retrospectively because the cumulative amount of change cannot be determined, it should be applied prospectively.

6.3.2 Disclosing a change in accounting policy

Retrospective adjustments should be reported as an adjustment to the opening balance of each affected component of equity in the statement of changes in equity.

Comparative information should also be restated unless it is impracticable to do so. In other words, all comparative information must be restated as if the new policy had always been in force, with amounts relating to earlier periods reflected in an adjustment to opening reserves of the earliest period presented.

In addition, disclosure is required in respect of:

(a) The initial application of an SFRS(I), including the title of the standard, transitional provisions, the nature of change in policy and the amount of any adjustments made.

(b) Voluntary changes in accounting policy including:

   (i) Reasons for the change
   (ii) Amount of the adjustment for the current period and for each period presented
   (iii) Amount of the adjustment relating to periods prior to those included in the comparative information
   (iv) The fact that comparative information has been restated or that it is impracticable to do so

(c) An assessment of the impact of new SFRS(I) on the financial statements where these have not yet come into force.
Example

The following disclosure note is taken from the Singapore Airlines Ltd Annual Report FY2017/18. Although the report refers to FRS rather than SFRS(I), the disclosure reflects the requirements of SFRS(I).

2(b) Changes in accounting policies

The accounting policies adopted are consistent with those of the previous financial year except as follows:

On 1 April 2017, the Group adopted all the new and revised standards and interpretations of FRS (‘INT FRS’) that are effective for annual periods beginning on or after 1 April 2017. The adoption of these standards and interpretations did not have any material effect on the financial performance or position of the Group and the Company.

Disclosure Initiative (Amendments to FRS 7)

Arising from amendments to FRS 7, which takes effect from 1 April 2017, the Group is required to provide additional disclosure in relation to the changes in liabilities arising from financial activities. Comparative information have not been presented (see note 38).


Example

The following is an extract of the Fraser & Neave Ltd Annual Report 2017. Although the report refers to FRS rather than SFRS(I), the disclosure reflects the requirements of SFRS(I).

38 New Accounting Standards and FRS Interpretation

Except for FRS 115, FRS 109 and FRS 116, the Directors expect that the adoption of the other new and amendments to standards above will have no material impact on the financial statements in the period of initial application. The nature of the impending changes in accounting policy on adoption of the following FRS are described below.

(a) FRS 115 Revenue from Contracts with Customers

FRS 115 establishes a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. FRS 115 will supersede the current revenue recognition guidance including FRS 18 Revenue, FRS 11 Construction Contracts and the related interpretations when it becomes effective. The core principle of FRS 115 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 in exchange for those goods or services. Under FRS 115, an entity recognises revenue when (or as) a performance obligation is satisfied i.e when ‘control’ of the goods or services underlying the particular performance obligation is transferred to the customer. Furthermore extensive disclosures are required by FRS 115.

The Group is currently determining the impact of the new accounting standard.

(b) FRS 109 Financial Instruments

FRS 109 Financial Instruments replaces the existing guidance in FRS 39 Financial Instruments: Recognition and Measurement. FRS 109 includes revised guidance on the classification and measurement of financial instruments including classification and measurement of financial assets, impairment of financial assets and hedge accounting. Retrospective application is required, but comparative information is not compulsory in the year of adoption.

The Group is currently determining the impact of the new accounting standard.
6: Presentation of financial statements and accounting policies

(c) **FRS 116 Leases**

FRS 116 Leases will result in almost all leases being recognised on the balance sheet, as the distinction between operating and finance leases is removed. Under the new standard, an asset (the right to use the leased item) and a financial liability to pay rentals are recognised, with exceptions to short-term and low-value leases. The accounting for lessors will not change significantly. The standard will affect primarily the accounting for the Group's operating leases.

The Group is currently determining the impact of the new accounting standard.

On 29 May 2014, the Accounting Standards Council (ASC) announced that Singapore-incorporated companies listed on SGX will apply a new financial reporting framework identical to the International Financial Reporting Standards (IFRS) for the financial year ending 31 December 2018 onwards. This means that the Group's comparative information for the financial year ended 30 September 2018 and the opening balance sheet as at 1 October 2017 would have to comply with this new financial reporting framework.


6.3.3 Use of accounting policies to alter profits

SFRS(I) 1-8 states that changes in accounting policies are rare, and only allowed if **required by statute/standard** or if the change results in **more relevant and reliable information**.

However, there is still some scope for directors to **alter the results** through change(s) of accounting policies. This would be done to avoid the effect of an old accounting policy or gain the effect of a new one. It is more likely to be done in a sensitive period, perhaps when the company's profits are low or the company is about to announce a rights issue. The management has to convince the auditors that the new policy is much better, but it is not difficult to produce reasons in such cases.

The effect of such a change is **very short-term**. Most analysts and sophisticated users will discount its effect immediately, except to the extent that it will affect any dividend (because of the effect on distributable profits). It may help to avoid breaches of banking covenants because of the effect on certain ratios.

Obviously, the accounting policy for any item in the accounts can only be changed voluntarily infrequently. No auditors would allow another change, even back to the old policy, unless there was a wholly exceptional reason.

The managers of a company can choose accounting policies **initially** to suit the company or the type of results they want to get. However, any subsequent voluntary changes in accounting policy must be justified, but some managers might try to change accounting policies to manipulate the results.

6.4 Changes in accounting estimates

Many items in the financial statements cannot be measured with precision and are instead estimated. These include the useful lives of assets and the level of irrecoverable debts.

Due to their nature, estimates may require revision if changes occur in the circumstances on which they were based or as the result of new information. For example the estimated useful life of an asset may be revised part-way through that useful life.

Where an accounting estimate is changed, the change is recognised **prospectively** by including it in profit or loss in the year of the change, and any future periods (where relevant).

The nature and amount of a change in accounting estimate that has an effect in the current or current and future periods is disclosed unless it is impracticable to estimate the effect.
6.5 Errors

There are a number of areas in the financial statements where errors can occur, including recognition, measurement, presentation, and/or disclosure.

Prior period errors are corrected by:

(a) Either restating the comparative amounts for the prior period(s) in which the error occurred, or

(b) When the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for that period

so that the financial statements are presented as if the error had never occurred. Where it is impracticable to determine the cumulative effect of an error on prior periods, an entity should restate the comparative information to correct the error prospectively from the earliest date practicable.

The following must be disclosed in relation to an error:

(a) Nature of the prior period error

(b) For each prior period, to the extent practicable, the amount of the correction:
   (i) For each financial statement line item affected
   (ii) If SFRS(I) 1-33 applies, for basic and diluted earnings per share

(c) The amount of the correction at the beginning of the earliest prior period presented

(d) If retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected

Subsequent periods need not repeat these disclosures.

Question 6.2

During 20X7 Pacific Plants Ltd discovered that certain items had been included in inventory at 31 December 20X6, valued at $4.2m, which had in fact been sold before the year-end. The following figures for 20X6 (as reported) and 20X7 (draft) are available.

<table>
<thead>
<tr>
<th></th>
<th>20X7 (draft)</th>
<th>20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>67,200</td>
<td>47,400</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>(55,800)</td>
<td>(34,570)</td>
</tr>
<tr>
<td>Profit before taxation</td>
<td>11,400</td>
<td>12,830</td>
</tr>
<tr>
<td>Income taxes</td>
<td>(3,400)</td>
<td>(3,880)</td>
</tr>
<tr>
<td>Net profit</td>
<td>8,000</td>
<td>8,950</td>
</tr>
</tbody>
</table>

Retained earnings at 1 January 20X6 were $13 million. The cost of goods sold for 20X7 includes the $4.2 million error in opening inventory. The income tax rate was 30% for 20X6 and 20X7.

Required

Show the statement of profit or loss and other comprehensive income for 20X7, with the 20X6 comparative, and a reconciliation of retained earnings.
SECTION SUMMARY

An entity should determine its accounting policies based on applicable SFRS(I)s and Interpretations. A change in accounting policy is only permitted when required by an SFRS(I) (or statute) or where it results in reliable and more relevant information. Any change in accounting policy is applied retrospectively; a change in an accounting estimate is applied prospectively; an error is corrected retrospectively.

7 Foreign currency transactions

SECTION INTRODUCTION

In Singapore it is very common for companies to enter into foreign currency transactions. SFRS(I) 1-21 The Effects of Changes in Foreign Exchange Rates provides guidance on how these transactions are accounted for.

7.1 Introduction

If a company trades overseas, it is likely to buy or sell goods in foreign currencies. For example, a company in Singapore might buy materials from Taiwan, and pay for them in US dollars, and then sell its finished goods in India, receiving payment in Rupees. If the company owes money in a foreign currency at the end of the accounting year, or holds assets which were bought in a foreign currency, those liabilities or assets must be translated into the local currency (in this Textbook, $), in order to be shown in the entity's books of account.

Equally, a company might have a subsidiary abroad, and the subsidiary will trade in its own local currency. The subsidiary will keep books of account and prepare its annual accounts in its own currency. However, at the year-end, the holding company must 'consolidate' the results of the overseas subsidiary into its group accounts, so to do so, the assets and liabilities and the annual profits of the subsidiary must be translated from the foreign currency into $.

SFRS(I) 1-21 provides guidance on the accounting treatment to be applied in both of these situations. In this chapter we deal with the first situation – accounting for foreign currency transactions in an individual company; later in the Textbook when we deal with group accounting, we shall consider the translation of a subsidiary's financial statements from one currency to another.

The 'local currency' referred to above is known as the functional currency of an entity in SFRS(I) 1-21. Before we consider the accounting treatment of foreign currency transactions, we shall consider a number of definitions provided in the standard and how to establish the functional currency of an entity.
7.2 Definitions

These are some of the definitions given by SFRS(I) 1-21.

KEY TERMS

FOREIGN CURRENCY A currency other than the functional currency of the entity.

FUNCTIONAL CURRENCY The currency of the primary economic environment in which the entity operates.

PRESENTATION CURRENCY The currency in which the financial statements are presented.

EXCHANGE RATE The ratio of exchange for two currencies.

EXCHANGE DIFFERENCE The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

CLOSING RATE The spot exchange rate at the period end date.

SPOT EXCHANGE RATE The exchange rate for immediate delivery.

MONETARY ITEMS Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. (SFRS(I) 1-21)

7.3 Functional currency

Each entity – whether an individual company, a parent of a group, or an operation within a group (such as a subsidiary, associate or branch) – should determine its functional currency and measure its results and financial position in that currency.

For most individual companies the functional currency will be the currency of the country in which they are located, and in which they carry out most of their transactions. Determining the functional currency is much more likely to be an issue where an entity operates as part of a group.

An entity can present its financial statements in any currency (or currencies) it chooses, and for most individual companies this will be the currency of the country in which it operates – for companies in Singapore, the Singapore dollar.

7.3.1 Determining functional currency

SFRS(I) 1-21 contains detailed guidance on how to determine an entity's functional currency. It states that the following must be considered:

(a) The currency:

   (i) That mainly influences sales prices for goods and services (usually the currency in which sales prices are denominated and settled)

   (ii) Of the country whose competitive forces and regulations mainly determine the sales price of its goods and services

(b) The currency that mainly influences labour, material and other costs of providing goods or services

The following may also provide evidence of an entity's functional currency:

(c) The currency in which funds from financing activities are generated

(d) The currency in which receipts from operating activities are usually retained
Where an entity is a foreign subsidiary, associate or other operation, the following factors are also relevant in determining functional currency and whether this is the same as the parent entity:

(e) Whether the activities of the foreign operation are carried out as an extension of the parent entity, rather than with a degree of autonomy

(f) Whether transactions with the parent entity are a high or low proportion of the foreign operation’s activities

(g) Whether cash flows from the activities of the foreign operation are sufficient to service debt obligations without funds from the parent entity

Where the functional currency is not obvious, management must apply judgment, giving priority to (a) and (b) above.

7.4 Accounting for foreign currency transactions

7.4.1 Initial recognition

SFRS(I) 1-21 states that a foreign currency transaction should be recorded on initial recognition in the functional currency, by applying the exchange rate between the reporting currency and the foreign currency at the date of the transaction to the foreign currency amount.

An average rate for a period may be used if exchange rates do not fluctuate significantly.

Example

Part 1
A Singapore company buys a large consignment of goods from a supplier in Germany. The order is placed on 1 May 20X2 and the agreed price is €124,250. At the time of delivery, the exchange rate was €1.6 to $1. The Singapore company would record the amount owed in its books as follows ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Inventory (124,250/1.6)</th>
<th>77,656</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Payables</td>
<td></td>
</tr>
</tbody>
</table>

(to recognise the purchase of goods from Germany)

7.4.2 Settlement date

When a transaction is settled in cash, it is likely that the exchange rate will have moved and therefore the payable or receivable amount (recorded in the functional currency) is not equal to the functional currency amount actually paid or received. This is best seen by way of an example.

Example

Part 2
Continuing with example 1 above, suppose that the German supplier is paid on 1 July 20X2 at which date the rate of exchange has altered to €1.7 to $1. The Singapore company has a year-end of 31 December, so the transaction arises and is settled within the same accounting period.

The cost of raising €124,250 would be (124,250/1.7) $73,088. The company would need to spend only $73,088 to settle a debt for purchases ‘costing’ $77,656. Since it would be administratively difficult to alter the value of the purchases in the company’s books of account, it is more appropriate to record an exchange gain on settlement of $4,568 ($). This is the treatment required by SFRS(I) 1-21, which states that exchange differences arise when exchange rates change between the recognition and settlement of outstanding amounts ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Payables</th>
<th>77,656</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td>CREDIT</td>
<td>Exchange gain</td>
<td>4,568</td>
</tr>
</tbody>
</table>

(to record settlement of the balance with the German supplier)
Exchange gains or losses are normally included in profit or loss for the year in which settlement (whether payment or receipt) takes place.

### 7.4.3 Reporting at subsequent year-ends

In our example, the transaction arose and was settled within the same accounting period. Where this is not the case, ‘foreign’ assets or liabilities are reported in the statement of financial position.

The following rules apply to this scenario:

(a) Foreign currency **monetary items** (eg loans, receivables and payables) are retranslated using the **closing rate**.

(b) **Non-monetary items** (eg non-current assets and inventories) which are carried at **historical cost** are not retranslated ie they remain in the financial statements translated at the rate that applied when they were purchased (**historical rate**).

(c) **Non-monetary items** which are carried at **fair value** are translated using the exchange rates that existed **when the values were measured**.

In some cases non-monetary items are measured at the lower of two amounts, for example:

- Inventory is measured at the lower of cost and net realisable value.
- Property, plant and machinery is measured at the lower of carrying amount and recoverable amount.

When performing such a comparison the cost/carrying amount of the asset in question is determined as explained in (b) and (c) above. The net realisable value or recoverable amount is translated at the exchange rate when that value was determined ie usually the closing rate at the end of the reporting period.

### 7.4.4 Transactions with advance consideration

SFRS(I) INT 22 addresses the situation in which a customer pays consideration in foreign currency in advance of a transaction, resulting in the seller recognising deferred income and the customer recognising a prepayment. At the transaction date (when the sale is recognised) the seller transfers the deferred income to be revenue and the customer transfers the prepayment to be an asset or expense.

The Interpretation clarifies that the advance consideration is translated at the spot exchange rate on the date that the deferred income/prepayment is recognised. The amount recognised is not remeasured using an up to date exchange rate when it is transferred to be revenue, an asset or an expense.

If a number of payments are made prior to the transaction date, each should be considered separately and translated by applying the exchange rate on the relevant date.

The interpretation does not apply if the related revenue, asset or expense if measured at fair value at initial recognition or if the fair value of the consideration transferred is required to be measured at a different date (eg when applying SFRS(I) 3) and does not apply to income taxes.

**Example**

Details of a sale transaction in foreign currency (FC) and exchange rates are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 August 20X5</td>
<td>FC40,000 deposit received</td>
<td>FC2:$1</td>
</tr>
<tr>
<td>1 September 20X5</td>
<td>Goods delivered</td>
<td>FC2.5:$1</td>
</tr>
<tr>
<td>30 November 20X5</td>
<td>FC60,000 balance becomes payable</td>
<td>FC2.4:$1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 September 20X5</td>
<td>FC60,000 balance</td>
<td>FC2.5:$1</td>
</tr>
<tr>
<td>30 November 20X5</td>
<td>FC60,000 balance paid</td>
<td>FC2.4:$1</td>
</tr>
</tbody>
</table>
The seller should make the following accounting entries ($):

### 1 August 20X5

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (FC40,000/2)</td>
<td>Deferred income</td>
</tr>
<tr>
<td>20,000</td>
<td>20,000</td>
</tr>
</tbody>
</table>

### 1 September 20X5

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivable (FC60,000/2.5)</td>
<td>Revenue</td>
</tr>
<tr>
<td>24,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Deferred income</td>
<td>Revenue</td>
</tr>
<tr>
<td>20,000</td>
<td>20,000</td>
</tr>
</tbody>
</table>

### 30 November 20X5

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (FC60,000/2.4)</td>
<td>Receivable</td>
</tr>
<tr>
<td>25,000</td>
<td>24,000</td>
</tr>
<tr>
<td></td>
<td>Exchange gain (P/L)</td>
</tr>
<tr>
<td></td>
<td>1,000</td>
</tr>
</tbody>
</table>

Therefore total revenue recognised in respect of the transaction is $44,000.

### 7.4.5 Recognition of exchange gains and losses

In most cases exchange gains and losses are recognised in profit or loss. The exceptions to this rule are:

- Where hedge accounting is applied (see Chapter 16)
- In the case of certain non-monetary assets

In the case of non-monetary assets, exchange gains or losses are recognised in the same way that changes in the underlying items are recognised. Therefore, for example, an exchange difference arising on a revalued property is recognised in other comprehensive income alongside the revaluation surplus/deficit.

### Example

**Part 3 (continued from Part 2 in section 7.4.2)**

Let's suppose that the Singapore company in the previous example has a year-end of 30 June, and at this date the exchange rate was €1.75 to $1. The company has not yet sold the goods purchased from the German company.

At the year-end the following ‘foreign currency’ amounts have been recognised in the financial statements:

- Inventory $77,656
- Payable $77,656

The inventory is not retranslated and is reported in the statement of financial position at $77,656. The payable is retranslated to $71,000 (124,250 ÷ 1.75), with any difference recognised as an exchange gain or loss by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payable (77,656 – 71,000)</td>
<td>Exchange gain</td>
</tr>
<tr>
<td>6,656</td>
<td>6,656</td>
</tr>
</tbody>
</table>

to retranslate the German payable at the year-end

When the balance is subsequently settled on 1 July 20X2 (as above) this is recorded by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payables</td>
<td>Exchange loss</td>
</tr>
<tr>
<td>71,000</td>
<td>2,088</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>73,088</td>
</tr>
</tbody>
</table>

to record settlement of the balance with the German supplier
You can see in this example that a $6,656 exchange gain is recognised at the reporting date and then a $2,088 exchange loss at the settlement date. These two amounts net off to the $4,568 gain seen in Part 2 of the example where the transaction and settlement took place in the same year.

Note that when a gain or loss on a non-monetary item is recognised in other comprehensive income (for example, where property is revalued), any related exchange differences should also be recognised in other comprehensive income.

### Question 6.3 Entries

Prosperity Biscuits Ltd, whose year-end is 31 December, buys some goods from Rink SA of France on 30 September. The invoice value is €40,000 and is due for settlement in equal instalments on 30 November and 31 January. The functional currency of Prosperity Biscuits is the Singapore dollar. The exchange rate moved as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 September</td>
<td>1.60</td>
</tr>
<tr>
<td>30 November</td>
<td>1.80</td>
</tr>
<tr>
<td>31 December</td>
<td>1.90</td>
</tr>
<tr>
<td>31 January</td>
<td>1.85</td>
</tr>
</tbody>
</table>

Required

State the accounting entries in the books of Prosperity Biscuits Ltd.

### Question 6.4 Revaluation

The Home Company Ltd operates a number of retail stores throughout Asia and has a year end of 31 December. The following information is relevant to a property owned by the company in Bangkok:

- **Cost on 1 January 20X1**: 100 million baht
- **Fair value on 31 December 20X4**: 139.2 million baht

The company applies the revaluation model to all properties and adopts a useful life of 50 years.

Relevant exchange rates are:

- **1 January 20X1**: $1: 20 baht
- **31 December 20X4**: $1: 24 baht

Required

What amounts are recognised in the financial statements of The Home Company Ltd in the year ended 31 December 20X4 in respect of the Bangkok property?

### SECTION SUMMARY

The functional currency of an entity is the currency in which it operates – normally the local currency. Where a foreign currency transaction takes place it is translated at the exchange rate on the date of the transaction (with the exception of advance consideration). Monetary items are subsequently retranslated at each reporting date with any exchange gains and losses recognised in profit or loss. On settlement any exchange gain or loss is also recognised in profit or loss.
8 Current developments

SECTION INTRODUCTION

The IASB has a number of projects on its workplan related to IAS 1 (SFRS(I) 1-1) and IAS 8 (SFRS(I) 1-8).

8.1 Proposed amendments to IAS 1

In February 2015, the IASB proposed amendments to IAS 1 (SFRS(I) 1-1) in order to clarify the criteria for the classification of a liability as either current or non-current.

In particular, the amendments address an apparent inconsistency within the standard. Currently, paragraph 69(d) of IAS 1 states that a liability is current when an entity does not have an unconditional right to defer settlement of that liability for at least 12 months after the reporting period. Paragraph 73 then states that an obligation is non-current if an entity expects, and has the discretion, to refinance or roll over an obligation for at least 12 months after the reporting period under an existing loan facility.

These paragraphs provide two inconsistent bases for the classification of a liability as non-current:

- An unconditional right to defer settlement for at least 12 months (in paragraph 69(d))
- An expectation, and the discretion, to roll over an obligation for at least 12 months (in paragraph 73)

In order to address this inconsistency, the IASB propose to delete the word ‘unconditional’ from paragraph 69(d) and change the word ‘discretion’ in paragraph 73 to ‘right’. As a result, it will be explicit that only rights in place at the end of a reporting period affect the classification of a liability.

In addition, two further amendments are proposed:

1. Including explanation of the link between a settlement of a liability and outflow of resources by stating within paragraph 69 that settlement refers to ‘the transfer to the counterparty of cash, equity instruments, other assets or services.’

2. Reorganisation of guidance in the standard to group similar examples together in order to distinguish between circumstances that do affect rights in existence at the reporting date and those that do not.

This project was halted in 2016 until the completion of the Conceptual Framework project (see Chapter 3); the project direction is expected to be decided during the course of 2018.

8.2 Proposed amendments to IAS 8

8.2.1 Accounting policies and accounting estimates

ED/2017/5 Accounting Policies and Accounting Estimates was issued in September 2017; it proposes that the definition of an accounting policy is amended to be clearer and more concise. The proposed definition is ‘specific principles, measurement bases and practices applied by an entity in preparing and presenting financial statements’.

The ED also proposes that the current definition of a change in accounting estimate is removed and replaced with a definition of accounting estimates, being ‘judgements or assumptions used in applying an accounting policy when, because of estimation uncertainty, an item in financial statements cannot be measured with precision’.
A further proposal would provide clarification within the standard that the selection of a cost formula to be applied to inventories (FIFO or AVCO) is the selection of an accounting policy, not an accounting estimate.

### 8.2.2 Accounting policy changes

ED/2018/1 Accounting Policy Changes was issued in March 2018. It proposes that IAS 8 be amended to make it easier for an entity to change accounting policy voluntarily as a result of an IFRS Interpretations Committee agenda decision. In such circumstances, it is proposed that an entity may depart from the requirement for retrospective application if it can show that the costs of retrospective application would exceed the expected benefits to users.

### 8.3 Proposed amendments to IAS 1 and IAS 8

ED/2017/6 Definition of Material proposes amendments to IAS 1 and IAS 8 to refine the definition of materiality and clarify its characteristics. The amendments are part of an overall objective of making the definition of material consistent throughout all IASB pronouncements.

The proposals would align the definition of material in both standards and modify it to:

- Refer to the fact that obscuring information has a similar effect to omitting information
- Change the phrase ‘could influence’ to ‘could reasonably be expected to influence’ and
- Emphasise primary users of financial statements.

### SECTION SUMMARY

Proposals to amend IAS 1 (SFRS(I) 1-1) and IAS 8 (SFRS(I) 1-8) are under consideration.
Chapter Roundup

SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors

- Accounting policies
  - Selection:
    - SFRS(I)s
    - Conceptual Framework
  - Changes if:
    - Required by SFRS(I)/statute
    - Reliable and more relevant information
  - Apply change retrospectively
  - Disclose

- Estimates
  - Apply change prospectively
  - Prior period adjustment if affects periods earlier than those presented

- Errors
  - Correct error retrospectively
**SFRS(I) 1-1 Presentation of Financial Statements**

- Statement of financial position (SOFP)
- Minimum disclosure of material line items
- Current/non-current classification
- Third statement where retrospective adjustment
- OCI split by:
  - From associates and joint ventures/other
  - Will not be/may be reclassified to profit or loss
- Allocate profit or loss and total comprehensive income to owners of parent and NCI

**Notes**
- SFRS(I) 1-7
- Accounting policies
- Judgments
- Assumptions
- Capital

**Comparative information**
**SFRS(I) 1-21 The Effects of Changes in Foreign Exchange Rates**

**Entity financial statements**

**Determine functional currency**
- Primary indicators
- Secondary indicators

**Statement of financial position**

**Statement of profit or loss and other comprehensive income**

**Initial recognition**
- Use spot exchange rate between functional and foreign currency on date of the transaction

**Exchange differences on**
- Monetary items in profit or loss

**Subsequent reporting dates**
- Monetary items at closing rate
- Non-monetary items at historic cost at date of the transaction

**Advance consideration translated at date paid/received and not subsequently retranslated**
Quick Quiz

1. When does SFRS(I) 1-1 require that a third statement of financial position is presented?
2. Under what circumstances is an asset classified as current?
3. How is other comprehensive income classified in the statement of profit or loss and other comprehensive income?
4. When may the requirements of SFRS(I)s be departed from?
5. Where there is no applicable accounting standard or interpretation, management should use its ____________ in developing and applying an accounting policy that results in information that is ____________ and ____________.
6. How are monetary assets and liabilities that are denominated in a foreign currency reported in the statement of financial position at the period end?
Answers to Quick Quiz

1. When an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

2. An asset is current when:
   (a) It is intended to be realised within the normal operating cycle of the entity
   (b) It is held primarily for trading
   (c) It is expected to be realised within 12 months after the reporting period, or
   (d) The asset is cash or a cash equivalent (as defined in SFRS(I) 1-7) unless the asset is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

3. Items of other comprehensive income (OCI) are classified by nature and grouped on the basis of whether they will be reclassified to profit or loss at a later date, in accordance with SFRS(I)s. OCI arising from investments in associates or joint ventures is disclosed separately.

4. In extremely rare circumstances, compliance with a requirement of an SFRS(I) may be so misleading that it would conflict with the objective of financial statements set out in the Conceptual Framework. In this instance an entity may depart from that specific requirement.

5. Where there is no applicable accounting standard or interpretation, management should use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable.

6. Monetary assets and liabilities are retranslated by applying the closing rate at the reporting date; any exchange gains or losses are recognised in profit or loss.

Answers to Questions

6.1 Departing from SFRS(I)

Although departure may be necessary in rare cases in order to achieve fair presentation, there are a number of drawbacks:

1. Companies must produce additional disclosure; this disclosure may confuse users of the accounts.
2. Auditors may disagree with the departure, potentially resulting in a qualified audit opinion.
3. Departure is likely to lead to increased costs because it increases the probability of litigation and may result in the intervention of regulatory bodies.
4. In the USA, the authorities continue to object to an override on the basis that it may lead to reduced comparability and transparency.
5. Market participants are likely to criticise any departure and may view the financial statements as being of lower quality.
6. Firms may depart from SFRS(I) in order to improve reported profitability, avoid the violation of covenants or increase managerial compensation i.e. use a departure to manipulate the accounts. Even where this is not the case, a departure may be perceived as being for this purpose.
### 6.2 Prior period error

**STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME**
**FOR THE YEAR ENDED 31 DECEMBER 20X7**

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td>67,200</td>
<td>47,400</td>
</tr>
<tr>
<td><strong>Cost of goods sold (W1)</strong></td>
<td>(51,600)</td>
<td>(38,770)</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>15,600</td>
<td>8,630</td>
</tr>
<tr>
<td><strong>Income tax (W2)</strong></td>
<td>(4,660)</td>
<td>(2,620)</td>
</tr>
<tr>
<td><strong>Net profit</strong></td>
<td>10,940</td>
<td>6,010</td>
</tr>
</tbody>
</table>

**RETAILED EARNINGS**

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening retained earnings</td>
<td>21,950</td>
<td>13,000</td>
</tr>
<tr>
<td>Correction of prior period error (4,200 – 1,260)</td>
<td>(2,940)</td>
<td>–</td>
</tr>
<tr>
<td>As restated</td>
<td>19,010</td>
<td>13,000</td>
</tr>
<tr>
<td>Net profit for year</td>
<td>10,940</td>
<td>6,010</td>
</tr>
<tr>
<td>Closing retained earnings</td>
<td>29,950</td>
<td>19,010</td>
</tr>
</tbody>
</table>

**Workings**

1. **Cost of goods sold**

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>As stated in question</td>
<td>55,800</td>
<td>34,570</td>
</tr>
<tr>
<td>Inventory adjustment</td>
<td>(4,200)</td>
<td>4,200</td>
</tr>
<tr>
<td></td>
<td>51,600</td>
<td>38,770</td>
</tr>
</tbody>
</table>

2. **Income tax**

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>As stated in question</td>
<td>3,400</td>
<td>3,880</td>
</tr>
<tr>
<td>Inventory adjustment (4,200 × 30%)</td>
<td>1,260</td>
<td>(1,260)</td>
</tr>
<tr>
<td></td>
<td>4,660</td>
<td>2,620</td>
</tr>
</tbody>
</table>

### 6.3 Entries

The purchase will be recorded in the books of Prosperity Biscuits Ltd using the rate of exchange on 30 September by ($):

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>DEBIT</strong></td>
<td><strong>CRedit</strong></td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>25,000</td>
<td>25,000</td>
</tr>
</tbody>
</table>

Being the $ cost of goods purchased for €40,000 (€40,000 ÷ €1.60/$1)

On 30 November, Prosperity Biscuits must pay €20,000. The accounts payable balance is revalued at this date = $22,222 (€40,000 ÷ €1.80/$1). This is recorded by ($):

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>DEBIT</strong></td>
<td><strong>CRedit</strong></td>
<td></td>
</tr>
<tr>
<td>Payables</td>
<td>2,778</td>
<td></td>
</tr>
<tr>
<td>Exchange gain</td>
<td></td>
<td>2,778</td>
</tr>
</tbody>
</table>

Half the balance is then paid €20,000 ÷ €1.80/$1 = $11,111. This is recorded by ($):

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>DEBIT</strong></td>
<td><strong>CRedit</strong></td>
<td></td>
</tr>
<tr>
<td>Payables</td>
<td>11,111</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>11,111</td>
</tr>
</tbody>
</table>
On 31 December, the year-end, the outstanding liability will be recalculated using the rate applicable to that date: €20,000 \( \div \) €1.90/$1 = $10,526. A further exchange gain of $585 has been made and will be recorded as follows ($):

\[
\begin{array}{ll}
\text{DEBIT} & \text{Payables} \quad \text{585} \\
\text{CREDIT} & \text{Exchange gain} \quad \text{585}
\end{array}
\]

The total exchange gain of $3,363 (2,778 + 585) will be included in the operating profit for the year ending 31 December.

On 31 January, Prosperity Biscuits must pay the second instalment of €20,000. This will cost them $10,811 (€20,000 \( \div \) €1.85/$1). This is recorded by ($):

\[
\begin{array}{ll}
\text{DEBIT} & \text{Payables} \quad \text{10,526} \\
\text{DEBIT} & \text{Exchange losses} \quad \text{285} \\
\text{CREDIT} & \text{Cash} \quad \text{10,811}
\end{array}
\]

### 6.4 Revaluation

The property is initially recognised at 100m baht/20 = $5 million.

It is depreciated for four years:

<table>
<thead>
<tr>
<th>Million baht</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>100</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(8)</td>
</tr>
<tr>
<td>Carrying amount</td>
<td>92</td>
</tr>
</tbody>
</table>

The property is revalued to 139.2m baht/24 = $5.8 million.

Therefore $5.8m – $4.6m = $1.2m is recognised in other comprehensive income. This amount is made up of:

- A revaluation surplus of (139.2m baht – 92m baht)/24 = $1,966,667
- An exchange loss of (92m baht/20) – (92m baht/24) = $766,667
PART D
Accounting for Assets
and Liabilities
You will be familiar with SFRS(I) 1-16 Property, Plant and Equipment from your previous studies. In this chapter we revise the requirements of that standard and consider those of SFRS(I) 1-23 Borrowing Costs.
1 Definitions

SECTION INTRODUCTION

The Conceptual Framework provides a broad definition of an asset; SFRS(I) 1-16 provides a number of additional definitions relevant to accounting for property, plant and equipment.

Assets have been defined in many different ways and for many purposes. The definition of an asset is important because it directly affects the treatment of such items. A robust definition will prevent abuse or error in the accounting treatment, otherwise some assets might be treated as expenses, and some expenses might be treated as assets.

Remember the definition of an asset in the Conceptual Framework.

KEY TERM

**Asset** A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

(Conceptual Framework)

The definition has three important characteristics:

- Future economic benefit
- Control
- The transaction to acquire control has already taken place
You will recall that SFRS(I) 1-1 Presentation of Financial Statements prescribes how an entity shall classify assets into current and non-current (SFRS(I) 1-1 paragraph 66).

**KEY TERM**

A **non-current asset** is an asset which is intended for use on a continuing basis in the company's activities, ie it is not intended for resale.

### 1.1 SFRS(I) 1-16 Definitions

SFRS(I) 1-16 takes our simple definition of an asset further in its definition of property, plant and equipment (PPE). This is one of a number of definitions provided in the standard.

**KEY TERMS**

**Property, plant and equipment** are tangible items 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

A **bearer plant** is a living plant that:

(a) Is used in the production or supply of agricultural produce;

(b) Is expected to bear produce for more than one period; and

(c) Has a remote likelihood of being sold as agricultural produce except for incidental scrap sales.

**Carrying amount** is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

**Cost** is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

**Depreciable amount** is the cost of an asset less its residual value.

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

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

**Useful life** is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by an entity.

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

A bearer plant as defined above is within the scope of SFRS(I) 1-16 rather than SFRS(I) 1-41 Agriculture. This is a plant such as a tea bush, grape vine or oil palm that is used to produce harvests that can be sold.
The standard does not apply to:

- Biological assets related to agricultural activity except bearer plants
- Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources
- Property, plant and equipment held for sale

**SECTION SUMMARY**

Property, plant and equipment are tangible items that:

- Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes
- Are expected to be used during more than one period

**2 Recognition and initial measurement**

**SECTION INTRODUCTION**

SFRS(I) 1-16 includes criteria for the recognition of property, plant and equipment. Items of property, plant and equipment are initially measured at cost.

**2.1 Recognition criteria**

Where an item of property, plant or equipment (PPE) meets the definition of an asset, recognition depends on two criteria:

1. It is probable that future economic benefits associated with the item will flow to the entity.
2. The cost of the item can be measured reliably.

These recognition criteria apply to subsequent expenditure as well as costs incurred initially.

For example, PCK Constructions Limited purchased a prime mover (truck) costing $200,000 and, separately, a repairs and maintenance package of $60,000 for three years.

In this case, the initial cost of PPE – Motor Vehicle $200,000 is capitalised and depreciated over the useful life of the asset as it meets the above recognition criteria.

Repairs and maintenance costs form an expense. In this case the repairs and maintenance package lasts for three years and is paid in advance. It is therefore recognised as a prepayment and $20,000 per year is transferred to be an expense in the statement of profit or loss.

**2.2 Application of recognition criteria**

SFRS(I) 1-16 provides guidance on the application of the recognition and measurement criteria in respect of some types of expenditure related to property, plant and equipment.

**2.2.1 Major spare parts and stand-by equipment**

Spare parts and stand-by equipment should be recognised as property, plant and equipment when they meet the definition of property plant and equipment. Otherwise they are classified as inventory and expensed as consumed.
2.2.2 Safety and environmental equipment

The acquisition of items of safety and environmental equipment may not directly increase future economic benefits which flow to an entity, however their acquisition may be necessary in order to generate future economic benefits from other assets in excess of those it would obtain otherwise. Where this is the case, expenditure on safety and environmental equipment qualifies for recognition as property, plant and equipment.

2.2.3 Complex assets

Where assets are large and made up of a number of different parts which have different useful lives and different depreciation rates, they are broken down into their constituent parts for accounting purposes. For example, the body and engines of an aircraft are separated as they have different useful lives. Expenditure incurred in replacing or renewing a component of an item of property, plant and equipment must be recognised in the carrying amount of the item (and then depreciated to the next replacement date).

2.2.4 Inspections and overhauls

Some items of property, plant and equipment require periodic overhauls or inspections in order to continue to operate. Examples of such assets are aircraft and ships, which require regular inspections to confirm airworthiness/seaworthiness. The cost of these overhauls/inspections should be included in the carrying amount of the relevant asset and depreciated as a separate element of the asset to the date of the next overhaul/inspection.

2.3 Initial measurement

Once recognised as an asset, items should initially be measured at cost. This includes:

- Purchase price, less trade discount/rebate
- Directly attributable costs of bringing the asset to working condition for intended use
- Initial estimate of the unavoidable costs of dismantling and removing the item and restoring the site on which it is located

SFRS(I) 1-16 provides examples of directly attributable costs included in the cost of an item of property, plant and equipment:

(a) Costs of employee benefits arising from the construction or acquisition of an asset
(b) Costs of site preparation
(c) Initial delivery and handling costs
(d) Installation and assembly costs
(e) Costs of testing whether an asset is functioning properly (after deducting the net proceeds from selling any items produced during the testing phase)
(f) Professional fees

Examples of costs that are not part of the cost of property, plant and equipment are:

- The costs of opening a new facility
- The costs of introducing a new product or service
- The costs of conducting business in a new location
- Administration and general overheads

Some incidental operations may occur in connection with the construction or development of an item of property, plant and equipment, 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. The income and related expenses of incidental operations are recognised in profit or loss.

Recognition of costs ceases when the asset is ‘in the location and condition necessary for it to be capable of operating in the manner intended by management’. The following costs would therefore be excluded from the carrying amount:

(a) Costs incurred after the asset is ready for normal use (even where the asset has yet to be brought into use or is operated at less than full capacity)
(b) Initial operating losses
(c) Costs of relocation or reorganisation of operations

2.3.1 Exchanges of assets

An item of property, plant and equipment may be acquired in exchange for another non-monetary asset. SFRS(I) 1-16 specifies that exchanges of items of property, plant and equipment, regardless of whether the assets are similar, are measured at fair value, unless the exchange transaction lacks commercial substance or the fair value of neither of the assets exchanged can be measured reliably. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

Example

PCK Construction Ltd traded in its old delivery van for $55,000 for a new bigger size delivery truck with fair value $180,000. The old delivery van has a carrying amount of $43,000 being cost $90,000 less accumulated depreciation $47,000 (which includes depreciation up until the date of disposal). The difference between $180,000 and $55,000 will be settled in cash of $125,000.

The journal entries are as follows ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated Depreciation</td>
<td>47,000</td>
</tr>
<tr>
<td>PPE – Delivery Truck</td>
<td>55,000</td>
</tr>
<tr>
<td>PPE – Delivery Van</td>
<td>90,000</td>
</tr>
<tr>
<td>Gain on Disposal</td>
<td>12,000</td>
</tr>
</tbody>
</table>

(to recognise disposal and part exchange of old delivery van for the new delivery truck)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>PPE – Delivery Truck</td>
<td>125,000</td>
</tr>
<tr>
<td>Cash</td>
<td>125,000</td>
</tr>
</tbody>
</table>

(to recognise the cash paid to acquire the new truck)

2.4 Current developments

In testing an item of property, plant or equipment whilst it is being prepared for its intended purpose, a company may produce items that can be sold.

In June 2017, the IASB issued ED/2017/4 Property, Plant and Equipment – Proceeds before Intended Use which proposes that IAS 16 (SFRS(I) 1-16) is amended to prohibit a company from deducting the proceeds of the sale of such items from the recognised cost of property, plant and equipment.
SECTION SUMMARY
A non-current asset is recognised when it is probable that future economic benefits will flow to the entity and it can be measured reliably. It is initially measured at cost including directly attributable costs of bringing the asset to working condition and estimated unavoidable future dismantling costs.

3 SFRS(I) 1-23 Borrowing Costs

SECTION INTRODUCTION
Borrowing costs may form part of the cost of an item of property, plant and equipment.

SFRS(I) 1-23 states that borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset.

3.1 Definitions
SFRS(I) 1-23 provides the following two definitions:

KEY TERMS
BORROWING COSTS Interest and other costs incurred by an entity in connection with the borrowing of funds.
QUALIFYING ASSET An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Note that qualifying assets are not only self-constructed assets, but may also be assets which have been purchased but which then take time to get ready for use/sale or bearer plants that are being cultivated before they are capable of producing saleable harvests. According to the standard, qualifying assets may include inventories, manufacturing plants, power generation facilities, intangible assets and investment properties.

Borrowing costs may include the following:
(a) Interest expense calculated using the effective interest method
(b) Finance charges in respect of lease liabilities
(c) Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

3.2 Accounting treatment
Eligible borrowing costs must be capitalised as part of the cost of a qualifying asset if they are directly attributable to its acquisition/construction/production. Other borrowing costs must be expensed in the period the cost is incurred.
3.2.1 Eligible borrowing costs

Borrowing costs eligible for capitalisation are those that would have been avoided if expenditure on the qualifying asset had not been made.

(a) Specific borrowings: Where an entity borrows funds specifically for the purpose of obtaining a qualifying asset, eligible borrowing costs are the actual borrowing costs incurred.

(b) General borrowings: Where an entity borrows funds generally and uses them to obtain a qualifying asset, eligible borrowing costs are calculated by applying the weighted average borrowing cost to expenditure on the qualifying asset. The total eligible borrowing costs must not exceed actual borrowing costs.

The amount of borrowing costs available for capitalisation is actual borrowing costs incurred less any investment income from temporary investment of those specific borrowings.

Where an entity has specific borrowings, any unused funds remaining when the entity has completed substantially all of the activities involved in getting the specified asset ready for use or sale, are transferred to be part of general borrowings. Therefore they (together with the applicable interest rate) are incorporated into the calculation of the weighted average borrowing cost (also known as weighted average capitalisation rate).

Judgment is required when looking at a group of entities to determine which general borrowings to include in the weighted average capitalisation rate. It may be appropriate in some cases to include all borrowings of a parent and its subsidiaries when calculating the weighted average borrowing costs, particularly where the treasury function is managed centrally within the group. Some groups of companies with little or no borrowing have subsidiaries that are engaged in constructing assets. A subsidiary may capitalise interest in its own financial statements on finance provided by another group entity in such circumstances. The intra-group interest is eliminated in the consolidated financial statements however, because the group as a whole has not incurred interest on those borrowings. Entities that finance the construction of qualifying assets from equity cannot capitalise the cost of equity or use a notional borrowing rate. The amount of borrowing costs that can be capitalised is limited to the actual borrowing costs incurred.

The standard does not address actual or imputed cost of equity.

3.2.2 Capitalisation period

Capitalisation commences when an entity first meets all three of the following conditions:
- It incurs expenditures for the asset
- It incurs borrowing costs
- It undertakes activities that are necessary to prepare the asset for its intended use or sale

Capitalisation is suspended if active development is interrupted for extended periods eg due to a strike by construction workers. However, capitalisation continues during periods when substantial technical and administrative work is being carried out. Capitalisation also continues when a temporary delay is a necessary part of the process of getting an asset ready for its intended use.

Capitalisation ceases when substantially all of the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

3.3 Disclosure

An entity must disclose:

- Amount of borrowing costs capitalised during the period
- Capitalisation rate used to determine borrowing costs eligible for capitalisation
**Question 7.1**

On 1 January 20X6 Ruan Peng Commercial (RPC) Ltd borrowed $15m to finance the production of two assets, both of which were expected to take a year to build. Production started 1 January 20X8 and the loan facility was drawn down on 1 January 20X8, and was utilised in the production of assets as follows, with the remaining funds invested temporarily.

<table>
<thead>
<tr>
<th></th>
<th>Asset X</th>
<th>Asset Y</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$m</td>
<td>$m</td>
</tr>
<tr>
<td>1 January 20X8</td>
<td>2.5</td>
<td>5.0</td>
</tr>
<tr>
<td>1 July 20X8</td>
<td>2.5</td>
<td>5.0</td>
</tr>
</tbody>
</table>

The loan rate was 10% and RPC Ltd can invest surplus funds at 8%.

**Required**

Ignoring compound interest, calculate the borrowing costs which may be capitalised for each of the assets and consequently the cost of each asset as at 31 December 20X8.

---

**Question 7.2**

Lim Yan Xu (LYX) Ltd had the following loans in place at the beginning and end of 20X8.

<table>
<thead>
<tr>
<th></th>
<th>1 January 20X8</th>
<th>31 December 20X8</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$m</td>
<td>$m</td>
</tr>
<tr>
<td>10.0% Bank loan repayable 20Y3</td>
<td>120</td>
<td>120</td>
</tr>
<tr>
<td>9.5% Bank loan repayable 20Y1</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>8.9% debenture repayable 20Y8</td>
<td>–</td>
<td>150</td>
</tr>
</tbody>
</table>

The 8.9% debenture was issued to fund the construction of a qualifying asset (a piece of mining equipment), construction of which began on 1 July 20X8. Construction activities were incomplete at 31 December 20X8.

On 1 January 20X8, LYX Ltd began construction of a qualifying asset, a piece of machinery for a hydro-electric plant, using existing borrowings. Expenditure drawn down for the construction was: $30 million on 1 January 20X8, $20m on 1 October 20X8.

**Required**

Calculate the borrowing costs to be capitalised for the hydro-electric plant machine. Use simple interest, payable annually.

---

**SECTION SUMMARY**

Eligible borrowing costs incurred whilst a qualifying asset is under construction or development are capitalised as part of the cost of an asset. Where an entity borrows funds generally and uses them to obtain a qualifying asset, eligible borrowing costs are calculated by applying the weighted average borrowing cost to expenditure on the qualifying asset. Borrowing costs cease to be capitalised when an asset is ready for its intended use.
4 Subsequent measurement

SECTION INTRODUCTION

Property, plant and equipment may be measured using either the cost model or the revaluation model.

The standard offers two possible treatments here, essentially a choice between keeping an asset recorded at cost or revaluing it to fair value (FV).

<table>
<thead>
<tr>
<th>Cost model</th>
<th>Revaluation model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>X</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(X)</td>
</tr>
<tr>
<td>Accumulated impairment losses</td>
<td>(X)</td>
</tr>
<tr>
<td>Carrying amount</td>
<td>X</td>
</tr>
<tr>
<td>FV at date of revaluation</td>
<td>X</td>
</tr>
<tr>
<td>Subsequent accumulated depreciation</td>
<td>(X)</td>
</tr>
<tr>
<td>Subsequent accumulated impairment losses</td>
<td>(X)</td>
</tr>
<tr>
<td>Carrying amount</td>
<td>X</td>
</tr>
</tbody>
</table>

Where the revaluation model is applied, it should be applied to an entire class of property, plant and equipment. For example, management may not revalue certain properties which it knows to have increased in value but hold other properties at cost. Impairment of property, plant and equipment is dealt with in Chapter 10.

4.1 Revaluation model

SFRS(I) 1-16 makes clear that the revaluation model is available only if the fair value of the item can be measured reliably.

4.1.1 Fair value

With the issue of SFRS(I) 13 Fair Value Measurement, all guidance in SFRS(I) 1-16 in relation to establishing fair value has been deleted. Instead the provisions of SFRS(I) 13 are applied (see Chapter 3).

This requires that fair value is measured as an ‘exit’ value, ie the price that could be achieved in a sale. In determining the fair value, the principal market for the asset is considered (or where there is no principal market, the most advantageous market) and the highest and best use of the asset.

Valuations might be carried out by internal valuers. Valuations are usually carried out by professionally qualified valuers. This is an important point to remember when undertaking a statutory audit (see SSA 620 Using the Work of an Auditor’s Expert).

4.1.2 Frequency of revaluations

The standard does not require valuations to be performed every year. The frequency of valuation depends on the volatility of the fair values of individual items of property, plant and equipment. The more volatile the fair value, the more frequently revaluations should be carried out such that the carrying amount of an asset at the reporting date does not differ materially from its fair value.

All the items within a class should be revalued at the same time, to prevent selective revaluation of certain assets and to avoid disclosing a mixture of costs and values from different dates in the financial statements. A rolling basis of revaluation is allowed if the revaluations are kept up to date and the revaluation of the whole class is completed in a short period of time.
4.1.3 Accounting for a revaluation

Where an asset increases in value, to recognise an upwards revaluation, the revaluation is recorded by:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>Other comprehensive income (revaluation surplus)</td>
</tr>
</tbody>
</table>

Where an asset decreases in value, to recognise a downwards revaluation, the revaluation is recorded by:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit or loss</td>
<td>Property, plant and equipment</td>
</tr>
</tbody>
</table>

Note the different treatment of the revaluation gain and loss: a gain is recognised as other comprehensive income and a loss is recognised as an impairment in profit or loss. This different treatment reflects the basic principle of prudence – recognising a loss when it is foreseen but not recognising a gain until it is realised.

The treatment may differ slightly where the asset in question has previously been the subject of a previous revaluation adjustment:

- Where an asset is revalued upwards but has previously been revalued downwards, the increase in value is recognised in profit or loss to the extent that a loss was previously recognised. Any excess is recognised as other comprehensive income.
- Where an asset is revalued downwards, but has previously been revalued upwards, the decrease in value is recognised as an item of other comprehensive income to the extent that it reverses a previous gain. Any excess is recognised in profit or loss.

Example

At the year-end of 31 October 20X3, Sentosa Properties Ltd has an item of freehold land carried in its books at $1.3 million. Two years ago in 20X1, a slump in land values led the company to reduce the carrying value from $1.5 million. This was taken as an expense in profit or loss for the year ended 31 October 20X1. There has been a surge in land prices in the current year ended 31 October 20X3, however, and the land is now worth $2 million.

Account for the revaluation in the current year ended 31 October 20X3.

Solution

The double entry is ($'000):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>700</td>
</tr>
<tr>
<td>Profit or loss for the year</td>
<td>200</td>
</tr>
<tr>
<td>Other comprehensive income (revaluation surplus)</td>
<td>500</td>
</tr>
</tbody>
</table>

Example

Let us simply swap round the example given above. The original cost was $1.5 million, revalued upwards to $2 million two years ago on 31 October 20X1. The value has now fallen to $1.3 million at year-end of 31 October 20X3.

Account for the decrease in value at 31 October 20X3.
Solution

The double entry is ($'000):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other comprehensive income (revaluation surplus)</td>
<td>500</td>
</tr>
<tr>
<td>Profit or loss for the year</td>
<td>200</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>700</td>
</tr>
</tbody>
</table>

SECTION SUMMARY

An entity may choose whether to apply the cost model or revaluation model. The same model must be applied to each asset in the same class. Where the revaluation model is applied, the carrying amount of assets should not differ materially from fair value. A revaluation increase is recognised as other comprehensive income and accumulated in a revaluation surplus and a revaluation decrease is recognised in profit or loss (unless reversing a previous revaluation).

5 Depreciation

SECTION INTRODUCTION

All items of property, plant and equipment other than most parcels of land are depreciated.

KEY TERM

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

Earlier in the chapter we met a number of definitions related to depreciation: depreciable amount, residual value and useful life.

The basic principle of depreciation is that the depreciable amount of an asset (its net cost to an entity, being initial cost less residual value) is spread over the asset’s useful life as the benefit of that asset is consumed. Depreciation commences when an asset is in the location and condition necessary to be capable of operating in the manner intended by management. It does not cease when an asset becomes idle unless the asset is already fully depreciated or has been derecognised or classified as held for sale.

All assets must be depreciated, with the exception of land that is not consumed. Land that is consumed and that must therefore be depreciated includes quarries and sites used for landfill. Where dismantling to restoration costs form part of the cost of land, these costs must be depreciated over the period that the entity benefits i.e. until the dismantling or restoration takes place and the costs are incurred. SFRS(I) 1-16 is clear that the repair and maintenance of an asset does not negate the need to depreciate it.
Question 7.3

What are the purposes of charging depreciation?

5.1 Calculating the depreciation charge

SFRS(I) 1-16 requires that the depreciable amount of an asset is allocated on a systematic basis over its useful life. The depreciation method used to allocate the depreciable amount must reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. A number of methods are available:

- **Straight line depreciation** results in a constant annual depreciation charge. This method simply spreads the depreciable amount evenly over the useful life. This method is sometimes referred to as the prime cost method.
- **Diminishing balance depreciation** results in a higher depreciation charge in the earlier years of an asset's useful life and a lower charge in later years. It is calculated as a constant percentage of an asset's carrying amount.
- **The units of production method** results in a charge based on expected output. The charge is therefore higher in periods of higher output and lower when there is a lower output.

There are other methods, such as the sum of the digits, but these are rarely used in practice.

SFRS(I) 1-16 does not permit a depreciation method that is based on the revenue generated by use of the asset. For example, a machine may cost $10,000 and be expected to produce goods for three years generating half of total revenue earned in the first year and then a quarter in each subsequent year. In this case, it would not be appropriate to charge depreciation of $5,000 in the first year and then $2,500 in each subsequent year based on the proportion of total revenue generated. This is not appropriate because revenue generated is affected by factors other than the consumption of the asset, e.g., price inflation and sales and marketing activities.

An entity must apply the selected depreciation method consistently unless a change in circumstances justifies a change. A change of method simply to increase profits is not allowed.

**Example**

An asset acquires a machine costing $300,000 with a residual value of $20,000 and a useful life of five years.

(a) What is the depreciation charge each year using the straight line method?

(b) What would be the depreciation charge each year based on the reducing (diminishing) balance method?

(c) What would be the depreciation charge each year based on units of production method if the machine produces the following units:

<table>
<thead>
<tr>
<th>Year</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>1,500</td>
</tr>
<tr>
<td>Year 2</td>
<td>3,600</td>
</tr>
<tr>
<td>Year 3</td>
<td>2,500</td>
</tr>
<tr>
<td>Year 4</td>
<td>1,400</td>
</tr>
<tr>
<td>Year 5</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>11,000</strong></td>
</tr>
</tbody>
</table>

(d) What is the depreciation charge each year using the sum of digits method?
Solution

(a) Straight line depreciation = (300,000 – 20,000)/5 years = $56,000 pa for five years

<table>
<thead>
<tr>
<th>Year</th>
<th>Cost</th>
<th>Dep</th>
<th>Carrying amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$300,000</td>
<td>$56,000</td>
<td>$244,000</td>
</tr>
<tr>
<td>2</td>
<td>$300,000</td>
<td>$112,000</td>
<td>$188,000</td>
</tr>
<tr>
<td>3</td>
<td>$300,000</td>
<td>$168,000</td>
<td>$132,000</td>
</tr>
<tr>
<td>4</td>
<td>$300,000</td>
<td>$224,000</td>
<td>$76,000</td>
</tr>
<tr>
<td>5</td>
<td>$300,000</td>
<td>$280,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

(b) Reducing balance depreciation = \( 1 - \frac{\text{Residual value} = 20,000}{\text{Cost} = 300,000} \) = 42% rounded

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation</th>
<th>Carrying amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$126,000</td>
<td>$174,000</td>
</tr>
<tr>
<td>2</td>
<td>$73,080</td>
<td>$100,920</td>
</tr>
<tr>
<td>3</td>
<td>$42,386</td>
<td>$58,534</td>
</tr>
<tr>
<td>4</td>
<td>$24,584</td>
<td>$33,950</td>
</tr>
<tr>
<td>5</td>
<td>$14,259</td>
<td>$19,691*</td>
</tr>
</tbody>
</table>

* Note that the residual value is slightly less than $20,000 as we used a rounded reducing balance percentage.

Alternatively the depreciation charge for year 5 can be adjusted to be $13,950, so resulting in a carrying amount of exactly $20,000 at the end of the year.

(c) Units of production method:

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation</th>
<th>Carrying amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$38,182</td>
<td>$261,818</td>
</tr>
<tr>
<td>2</td>
<td>$91,636</td>
<td>$170,182</td>
</tr>
<tr>
<td>3</td>
<td>$63,636</td>
<td>$106,546</td>
</tr>
<tr>
<td>4</td>
<td>$35,636</td>
<td>$70,910</td>
</tr>
<tr>
<td>5</td>
<td>$50,910</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

(d) Sum of digits = \( \frac{n(n+1)}{2} \) = \( \frac{5(5+1)}{2} \) = 15 or 5 + 4 + 3 + 2 + 1 = 15

Depreciable amount = $300,000 – $20,000 = $280,000

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation</th>
<th>Carrying amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$93,333</td>
<td>$206,667</td>
</tr>
<tr>
<td>2</td>
<td>$74,667</td>
<td>$132,000</td>
</tr>
<tr>
<td>3</td>
<td>$56,000</td>
<td>$76,000</td>
</tr>
<tr>
<td>4</td>
<td>$37,333</td>
<td>$38,667</td>
</tr>
<tr>
<td>5</td>
<td>$18,667</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Example

The management of Queenstown Couriers Ltd has recently purchased a new delivery van. Explain to them whether you believe the straight line or diminishing balance depreciation method would be most appropriate for this asset.
**Solution**

The diminishing balance method of depreciation is used instead of the straight line method when it is considered fair to allocate a greater proportion of the total depreciable amount to the earlier years and a lower proportion to the later years on the assumption that the benefits obtained by the business from using the asset decline over time.

It may be argued that this method links the depreciation charge to the costs of maintaining and running the delivery van, and on this basis is likely to be the most appropriate method. In the early years these costs are low and the depreciation charge is high, while in later years this is reversed.

**5.2 Accounting for depreciation**

The depreciation of an asset begins when the asset is available for use. The depreciation charge in a year is usually recognised in profit or loss and recorded by:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense (profit or loss)</td>
<td>Accumulated depreciation</td>
</tr>
</tbody>
</table>

To record annual depreciation.

In some circumstances depreciation is accounted for by the entity as part of the cost of producing other assets. For example, depreciation of plant and machinery can be incurred in the production of goods for sale (inventory items). In such circumstances, the depreciation is included in the cost of the new assets produced rather than as a separate expense.

**5.3 Depreciation and revalued assets**

If the revaluation model is adopted, the carrying amount of an asset is adjusted to fair value at each revaluation date. As we have seen, in the case of an upwards revaluation, this results in a credit to other comprehensive income. Where the revalued asset is depreciable, the corresponding debit entry must be allocated between a cost/valuation account and an accumulated depreciation account. SFRS(I) 1-16 suggests different ways in which this might be achieved, however it does not advocate one method over another.

It states:

(a) The gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses; or

(b) The accumulated depreciation is eliminated against the gross carrying amount of the asset.

Note: This Textbook assumes that the method set out in SFRS(I) 1-16 paragraph 35(b) is adopted.

The following example will help to illustrate this:

**Example**

At 31 December 20X4 (the year end), a machine is carried in Cole Design Ltd's accounts at a cost of $50,000 less accumulated depreciation of $10,000. The company wants to revalue the machine to its fair value of $60,000. A new machine of the same type would cost $72,000. What journals may be used to record the revaluation?
Solution

Perhaps the easiest method to record the revaluation of $20,000 ($60,000 – $40,000) involves eliminating all depreciation to date and adjusting the cost/valuation account to fair value. Therefore ($'000):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$90</td>
<td>Machine cost/valuation (60 – 50) 10</td>
</tr>
<tr>
<td>$10</td>
<td>Accumulated depreciation 10</td>
</tr>
<tr>
<td></td>
<td>Other comprehensive income (revaluation surplus) 20</td>
</tr>
</tbody>
</table>

Therefore after the revaluation, cost/valuation is $60,000 and accumulated depreciation thereon is nil.

A second method involves restating the cost/valuation account and then adjusting accumulated depreciation to ensure the correct carrying amount. Restatement of cost/valuation may be proportionate to the revaluation increase, or in line with observable market data.

(i) Proportionate to the revaluation increase

The revaluation increases carrying amount from $40,000 to $60,000 ie it increases by 50%.

Therefore cost/valuation is increased by 50%. The credit to accumulated depreciation is a balancing figure to ensure that the revaluation surplus is $20,000. The journal is ($'000):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$25</td>
<td>Machine cost/valuation ((50 × 150%) – 50) 25</td>
</tr>
<tr>
<td></td>
<td>Accumulated depreciation 5</td>
</tr>
<tr>
<td></td>
<td>Other comprehensive income (revaluation surplus) 20</td>
</tr>
</tbody>
</table>

Therefore after the revaluation, cost/valuation is $75,000 and accumulated depreciation thereon is $15,000 ($10,000 + $5,000).

(ii) In line with observable market data

Cost is increased to $70,000, being the cost of a new machine and again the adjustment to accumulated depreciation is a balancing figure to ensure that the revaluation surplus is $20,000. The journal is ($'000):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$22</td>
<td>Machine cost/valuation (72 – 50) 22</td>
</tr>
<tr>
<td></td>
<td>Accumulated depreciation 2</td>
</tr>
<tr>
<td></td>
<td>Other comprehensive income (revaluation surplus) 20</td>
</tr>
</tbody>
</table>

Therefore after the revaluation, cost/valuation is $72,000 and accumulated depreciation thereon is $12,000 ($10,000 + $2,000).

After a revaluation, subsequent depreciation is calculated based on the revalued amount and the asset's remaining useful life. Therefore, an upward revaluation means that the depreciation charge will increase.

Example

Lucky Foods Pte Ltd bought an asset for $10,000 at the beginning of 20X6. It had a useful life of five years and no residual value. On 1 January 20X8 the asset was revalued to $12,000. The expected useful life has remained unchanged (ie three years remain).

Account for the revaluation and state the treatment for depreciation from 20X8 onwards.
Solution

On 1 January 20X8 the carrying value of the asset is $10,000 – (2 × ($10,000/5)) = $6,000. For the revaluation ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>Other comprehensive income (revaluation surplus)</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></td>
</tr>
</tbody>
</table>

2,000
4,000
6,000


to recognise the revaluation of the asset

The depreciation for the next three years will be $12,000/3 = $4,000 and is recognised by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense</td>
<td>Accumulated depreciation</td>
</tr>
</tbody>
</table>

4,000
4,000


to record depreciation on the revalued asset

Normally, a revaluation surplus is only realised when the asset is derecognised, but when it is being used by the entity, part of that surplus is being realised as the asset is used. The amount of the surplus realised is the difference between depreciation charged on the revalued amount and the (lower) depreciation which would have been charged on the asset's original cost. This amount can be transferred to retained (ie realised) earnings but not through profit or loss.

Example

Continuing with the example above:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original depreciation charge (10,000/5years)</td>
<td>$2,000</td>
</tr>
<tr>
<td>Revised depreciation charge (12,000/3 years)</td>
<td>$4,000</td>
</tr>
<tr>
<td>Extra depreciation per annum as a result of revaluation</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

This amount can be transferred by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revaluation surplus</td>
<td>Retained earnings</td>
</tr>
</tbody>
</table>

2,000
2,000

To transfer realised amounts from the revaluation surplus to retained earnings.

5.4 Depreciation, judgment and estimates

A number of estimates are employed when measuring depreciation:

- Residual value
- Useful life
- Depreciation method (ie which method best reflects consumption of the asset)

SFRS(I) 1-16 provides limited guidance on how judgment should be applied to establish residual value, however it does state that residual value is often insignificant. Where residual value exceeds an asset's carrying amount, the asset's depreciation charge is zero.

The standard states that the following should be considered when establishing useful life:

(a) Expected usage of the asset by reference to capacity or output
(b) Expected physical wear and tear including number of shifts for which an asset is to be used and the care and maintenance of the asset whilst idle
(c) Obsolescence of the asset due to changes in production techniques or market demand for the output

(d) Legal or similar limits on use of the asset

The standard is also clear that useful life is defined in terms of the asset's expected utility to the entity, and therefore it may be shorter than the asset's economic life.

It is the nature of estimates that they may change over time, and where this is the case, the new estimates apply on a prospective basis i.e. future depreciation charges are amended, but historic depreciation charges are not.

SFRS(I) 1-16 requires that the residual value and useful life of an asset together with the depreciation method are reviewed at least at each financial year-end, and changed where revised estimates differ significantly from previous estimates.

Where the depreciation method is changed, the effect should be quantified and disclosed and the reason for the change should be stated in accordance with SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors.

Example

An asset cost $100,000 at the start of 20X3 and was estimated to have a useful life of ten years and residual value of $8,000. The straight line depreciation method was applied. At the end of 20X7, the estimated remaining useful life was amended to be three years and the residual value was amended to be nil.

What is the depreciation charge in 20X8?

Solution

<table>
<thead>
<tr>
<th>Description</th>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial depreciation charge</td>
<td>(100,000 – 8,000)/10 yrs</td>
<td>$9,200</td>
</tr>
<tr>
<td>Carrying amount at end 20X7</td>
<td>100,000 – (9,200 × 5 yrs)</td>
<td>$54,000</td>
</tr>
<tr>
<td>Subsequent depreciation charge</td>
<td>54,000/3 yrs</td>
<td>$18,000</td>
</tr>
</tbody>
</table>

Example

An asset cost $200,000 at the start of 20X1 and was assessed to have a useful life of 20 years with no residual value. Depreciation was calculated using the straight line method. At the end of 20X4, management believed that reducing balance depreciation at a rate of 10% would better reflect the consumption of benefits associated with the asset.

What is the depreciation charge in 20X5 and 20X6?

Solution

<table>
<thead>
<tr>
<th>Description</th>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial depreciation charge</td>
<td>200,000/20 yrs</td>
<td>$10,000</td>
</tr>
<tr>
<td>Carrying amount at end 20X4</td>
<td>200,000 – (10,000 × 4 yrs)</td>
<td>$160,000</td>
</tr>
<tr>
<td>Depreciation charge 20X5</td>
<td>160,000 × 10%</td>
<td>$16,000</td>
</tr>
<tr>
<td>Depreciation charge 20X6</td>
<td>(160,000 – 16,000) × 10%</td>
<td>$14,400</td>
</tr>
</tbody>
</table>
SECTION SUMMARY

All assets with the exception of land that is not consumed must be depreciated. An asset's depreciable amount is spread over its useful life on a systematic basis (usually using either the straight line, diminishing balance or units of production method). Depreciation is charged on revalued assets based on the revalued amount; the difference between the original and new depreciation charge can be the subject of a reserves transfer. The useful life, residual value and depreciation method must be reviewed annually and any change applied prospectively.

6 Disposals

SECTION INTRODUCTION

Assets are derecognised when they are no longer expected to generate future economic benefits.

An asset is derecognised from the statement of financial position when it is permanently withdrawn from use, sold or scrapped, and it is not expected to generate future economic benefits.

Gains or losses are the difference between the net disposal proceeds and the carrying amount of the asset. They should be recognised as income or expense in profit or loss (unless SFRS(I) 16 Leases requires otherwise on a sale and leaseback). An entity cannot classify a gain it realises on the disposal of an item of property, plant and equipment as revenue. Intended disposal of property, plant and equipment is classified as held-for-sale, which is dealt with in Chapter 21.

6.1 Disposal of a revalued asset

When a revalued asset is disposed of, any revaluation surplus may be transferred directly to retained earnings.

Alternatively, it may be left in equity under the heading revaluation surplus.

The transfer to retained earnings should not be made through profit or loss for the year. In other words it must not be made as a reclassification adjustment ('recycled').

Example

Y Trading Ltd purchased a property at a cost of $20 million several years ago. At this time the useful life was assessed to be 50 years. At the end of Year 10, the property was revalued to $26 million and its useful life remains unchanged. The property was sold at the beginning of Year 20 for $28 million.

What accounting entries are required on the disposal assuming that Y Trading Ltd maximises its retained earnings?

Solution

(a) The property is depreciated each year until year 10 by $400,000 (20m/50 yrs)
(b) At the date of revaluation the carrying amount of the property was $16m (20m – (10 yrs × 400)).
(c) The revaluation surplus arising at the end of year 10 was therefore $10m (26m – 16m)
(d) Over the next 10 years, the asset is depreciated by $650,000 (26m/40 yrs) per annum giving a carrying amount at the beginning of year 20 of $20.15m (26m – (9 yrs × 650))

(e) In each year for years 11 to 19 Y Trading will transfer the excess depreciation of $250,000 (650 – 400) from the revaluation surplus to retained earnings by way of a transfer from revaluation surplus in order to maximise retained earnings.

(f) Therefore at the date of disposal the revaluation surplus is $7.75m (10m – (9 yrs × 250))

On disposal the accounting entries are therefore ($’000):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Cash</td>
</tr>
<tr>
<td>Property, plant and equipment @ carrying amount</td>
<td>Property, plant and equipment @ carrying amount</td>
</tr>
<tr>
<td>Gain on disposal</td>
<td>28,000</td>
</tr>
<tr>
<td>20,150</td>
<td>7,850</td>
</tr>
</tbody>
</table>

To record the disposal and

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revaluation surplus</td>
<td>Revaluation surplus</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>Retained earnings</td>
</tr>
<tr>
<td>7,750</td>
<td>7,750</td>
</tr>
</tbody>
</table>

To transfer the balance on the revaluation surplus to retained earnings.

**SECTION SUMMARY**

An asset is derecognised when it is sold, scrapped or withdrawn from use and is no longer expected to generate future economic benefits to the entity. Any gain or loss is calculated as the difference between net proceeds and carrying amount and this is recognised in profit or loss. Where a revalued asset is disposed of, the balance on the revaluation surplus in respect of the asset may be transferred to retained profits.

**7 Disclosure**

**SECTION INTRODUCTION**

SFRS(I) 1-16 requires that details of depreciation, carrying amounts and revaluations are disclosed in the financial statements. You should refer to SFRS(I) 1-16 for full details of the disclosure requirements. The key disclosures are summarised below.

For each class of property, plant and equipment, the following must be disclosed:

(a) The measurement bases used for determining gross carrying amount

(b) Depreciation methods used

(c) Useful lives or depreciation rates used

(d) The gross carrying amount and accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period

(e) A reconciliation of the carrying amount at the beginning and end of the period
In addition the following amounts are disclosed in aggregate:

(a) The existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities
(b) The amount of expenditure recognised in the carrying amount of an asset under construction
(c) Contractual commitments for the purchase of property, plant and equipment
(d) If not disclosed elsewhere, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in profit or loss.

Where items of property, plant and equipment are stated at a revalued amount, the following is disclosed in addition to disclosures required by SFRS(I) 13:

(a) The effective date of the revaluation
(b) Whether an independent valuer was involved
(c) The carrying amount of each revalued class of property, plant and equipment had the cost model been applied
(d) The amount of the revaluation surplus and the change for the period and any restrictions on the distribution of the balance to shareholders.

You should refer to Chapter 3 for the disclosures required by SFRS(I) 13; the following example incorporates SFRS(I) 13 disclosures.

Example

The following is an extract from the Far East Orchard Limited Annual Report 2017 showing the property, plant and equipment disclosure.


20. Property, plant and equipment

<table>
<thead>
<tr>
<th></th>
<th>Freehold and leasehold land</th>
<th>Plant, equipment, furniture and fittings</th>
<th>Construction -in-progress</th>
<th>Motor vehicles</th>
<th>Other assets</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Group – 2017</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost or valuation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning of financial year</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>366,144</td>
<td>181,016</td>
<td>3,119</td>
<td>1,046</td>
<td>4,243</td>
<td>67,797</td>
</tr>
<tr>
<td>Valuation</td>
<td>366,114</td>
<td>181,016</td>
<td>3,119</td>
<td>1,046</td>
<td>4,243</td>
<td>547,130</td>
</tr>
<tr>
<td>Currency translation differences</td>
<td>165</td>
<td>447</td>
<td>32</td>
<td>(4)</td>
<td>(3)</td>
<td>637</td>
</tr>
<tr>
<td>Additions</td>
<td></td>
<td></td>
<td>1,453</td>
<td>2,262</td>
<td>5</td>
<td>3,720</td>
</tr>
<tr>
<td>Disposals</td>
<td></td>
<td></td>
<td>(59)</td>
<td>(479)</td>
<td></td>
<td>(538)</td>
</tr>
<tr>
<td>Cost adjustments</td>
<td></td>
<td></td>
<td>(3,979)</td>
<td>–</td>
<td>–</td>
<td>(3,979)</td>
</tr>
<tr>
<td>Revaluation adjustments:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– Profit or loss</td>
<td></td>
<td></td>
<td>(6,529)</td>
<td>–</td>
<td>–</td>
<td>(6,529)</td>
</tr>
<tr>
<td>– Other comprehensive income (note 27(ii))</td>
<td>2,987</td>
<td>(13,871)</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>(10,884)</td>
</tr>
<tr>
<td>End of financial year</td>
<td>369,266</td>
<td>157,084</td>
<td>60,815</td>
<td>5,377</td>
<td>567</td>
<td>4,245</td>
</tr>
<tr>
<td>Representing:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>369,266</td>
<td>157,084</td>
<td>60,815</td>
<td>5,377</td>
<td>567</td>
<td>4,245</td>
</tr>
<tr>
<td>Valuation</td>
<td>369,266</td>
<td>157,084</td>
<td>60,815</td>
<td>5,377</td>
<td>567</td>
<td>4,245</td>
</tr>
</tbody>
</table>

SFRS(I) 1-1 SFRS(I) 1-16 para 74
Property, plant and equipment of the Group with carrying amounts $185,727,000 (2016: $255,456,000) are provided as security for bank borrowings (Note 23).

The freehold and leasehold land and buildings of the Group and Company with carrying values of $526,350,000 (2016: $305,599,000) and $309,576,000 (2016: $305,599,000) respectively are carried at the revalued amounts in accordance with the Group's accounting policy as described in Note 2.4. If these land and buildings were included in the financial statements at cost less accumulated depreciation and impairment losses, their net book values would have been $179,584,000 (2016: $187,560,000) and $2,183,000 (2016: $2,183,000) respectively.

Valuation processes, techniques and inputs for Level 3 fair value measurements

The Group engages external, independent and qualified valuers to determine the fair value of the Group's property, plant and equipment on a triennial basis and whenever their carrying amounts are likely to differ materially from their revalued amounts, based on the properties' highest and best use. The following table presents the valuation techniques and key inputs (as described in Note 19) that were used to determine the fair value which is categorised under Level 3 of the fair value hierarchy.

<table>
<thead>
<tr>
<th>Description</th>
<th>Fair value at 31 December</th>
<th>Valuation technique(s)</th>
<th>Significant unobservable input(s) and range</th>
<th>Relationship of unobservable inputs to fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2017 $000</td>
<td>2016 $000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Freehold and leasehold land</td>
<td>309,576</td>
<td>305,599</td>
<td>Income capitalisation</td>
<td>The lower the capitalisation rate, the higher the fair value</td>
</tr>
<tr>
<td>– Singapore</td>
<td></td>
<td></td>
<td>Capitalisation rate – 3.8% to 4.5% (2016: 4.0% to 5.0%)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sales comparison</td>
<td>The higher the comparable sales price the higher the fair value</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Pre-adjusted comparable sales price – $2,918 to $6,779 (2016: $2,918 to $6,792) psf</td>
<td></td>
</tr>
<tr>
<td>Description</td>
<td>Fair value at 31 December</td>
<td>Valuation technique(s)</td>
<td>Significant unobservable input(s) and range</td>
<td>Relationship of unobservable inputs to fair value</td>
</tr>
<tr>
<td>-------------</td>
<td>--------------------------</td>
<td>------------------------</td>
<td>---------------------------------------------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>Freehold land and building (2016: Freehold land – Malaysia)</td>
<td>40,412</td>
<td>48,676</td>
<td>Discounted cash flow</td>
<td>Discount rate – 8.0% (2016: 8.0%) Terminal yield – 6.0% (2016: 6.0%)</td>
</tr>
<tr>
<td>Freehold land and buildings – Australia</td>
<td>176,362</td>
<td>192,855</td>
<td>Discounted cash flow</td>
<td>Net profit margin – 11.7% to 28.8% (2016: 16.1% to 31.0%) Discount rate – 8.0% to 8.5% (2016: 8.0% to 9.3%) Terminal yield – 6.8% to 7.5% (2016: 6.8% to 8.0%)</td>
</tr>
<tr>
<td>Income capitalisation</td>
<td></td>
<td></td>
<td>Capitalisation rate – 6.0% to 7.0% (2016: 6.0% to 7.5%)</td>
<td>The lower the capitalisation rate, the higher the fair value</td>
</tr>
</tbody>
</table>

**SECTION SUMMARY**

The main SFRS(I) 1-16 disclosure is a reconciliation of the carrying amount of each class of property, plant and equipment at the start of the period to the end of the period. In addition, details of depreciation and revaluations must be provided.
Chapter Roundup

SFRS(I) 1-16 Property, Plant and Equipment

**Recognition**
- Tangible
- Held for use, rental to others or administration
- Held for more than one period

**Measurement**
- Probable economic benefits
- Reliable measurement

**Disposals**

**Disclosure**

- Initial
  - Purchase price
    - Directly attributable costs
    - Dismantling costs

- Subsequent
  - Cost model
    - Cost – accumulated depreciation – impairment losses
  - Revaluation model
    - Revalued amount
      - Subsequent depreciation – subsequent impairment losses

- Revalue the asset
  - Recognise in OCI

- Depreciate over useful life using method to reflect consumption of economic benefits of asset

SFRS(I) 13 Fair Value Measurement

Tangible
- Held for use, rental to others or administration
- Held for more than one period
Quick Quiz

1. How does the Conceptual Framework define an asset?
2. How might an item of property, plant and equipment be defined?
3. What is a qualifying asset for the purposes of SFRS(I) 1-23 Borrowing Costs?
4. What are the SFRS(I) 1-16 rules where the revaluation model is applied?
5. How is a revaluation loss accounted for?
6. How often should depreciation estimates be reviewed?
7. What adjustment can be made to reserves on the disposal of a revalued asset?
Answers to Quick Quiz

1. A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

2. A tangible asset intended for use on a continuing basis in the company's activities (e.g., greater than one year).

3. An asset which necessarily takes a substantial period of time to get ready for its intended use or sale.

4. The revaluation model must be applied consistently across a class of assets; carrying amounts must be kept up to date such that they do not differ significantly from fair value.

5. A revaluation loss is recognised in profit or loss unless it is the reversal of a previous revaluation gain in which case it is recognised as other comprehensive income to the extent that it reverses the gain.

6. Useful life, residual value and depreciation method should be reviewed at each reporting date.

7. The balance on the revaluation surplus in respect of the asset may be transferred to retained earnings.

Answers to Questions

7.1 Borrowing costs 1

<table>
<thead>
<tr>
<th></th>
<th>Asset X ($'000)</th>
<th>Asset Y ($'000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrowing costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To 31 December 20X8</td>
<td>$5.0m × 10%/10m × 10%</td>
<td>500</td>
</tr>
<tr>
<td>Less investment income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To 30 June 20X8</td>
<td>$2.5m × 8% × 6/12/$5.0m × 8% × 6/12</td>
<td>(100)</td>
</tr>
<tr>
<td>Cost of assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditure incurred</td>
<td>5,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Borrowing costs</td>
<td>400</td>
<td>800</td>
</tr>
<tr>
<td></td>
<td>5,400</td>
<td>10,800</td>
</tr>
</tbody>
</table>

7.2 Borrowing costs 2

\[
\text{Capitalisation rate} = \text{weighted average rate} = (10\% \times \frac{120}{120+80}) + (9.5\% \times \frac{80}{120+80}) = 9.8\%
\]

\[
\text{Borrowing costs} = ($30m \times 9.8\%) + ($20m \times 9.8\% \times 3/12) = $3.43m
\]

7.3 Depreciation

The accounts of a business are required to recognise that the cost of a non-current asset is gradually consumed as the asset wears out. This is done by gradually writing off the asset's cost in profit or loss over several accounting periods, so matching the cost of the asset to the revenues which it is used to generate and therefore the period over which the economic benefits of the asset are consumed. This process is known as depreciation, and is an example of the accrual assumption. Depreciation should be allocated on a systematic basis to each accounting period during the useful life of the asset.

With regard to the accrual principle, it is fair that the profits should be reduced by the depreciation charge, but this is not a haphazard exercise. Depreciation is not, as is sometimes supposed, an attempt to set aside funds to purchase new long-term assets when required. Depreciation is not generally provided on freehold land because it does not ‘wear out’ (unless it is held for mining).
Investment properties are a particular type of non-current asset which are accounted for in accordance with SFRS(I) 1-40 *Investment Property* rather than SFRS(I) 1-16 *Property, Plant and Equipment*.

This chapter defines an investment property before dealing with the relevant accounting and disclosure requirements. It also covers the accounting treatment of government grants as set out in SFRS(I) 1-20 *Accounting for Government Grants and Disclosure of Government Assistance*.
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measurement and Reporting</strong></td>
<td></td>
</tr>
<tr>
<td>Apply, explain and evaluate accounting standards for major classes of assets, insofar as they affect initial recognition, measurement (including initial measurement and subsequent re-measurement), classification and disclosure, and de-recognition from an entity's statement of financial position.</td>
<td>3</td>
</tr>
<tr>
<td><strong>Specific Applications (Assets)</strong></td>
<td></td>
</tr>
<tr>
<td>Apply the relevant accounting treatment on the following classes of assets: Investment property.</td>
<td>3</td>
</tr>
<tr>
<td><strong>Emerging Trends</strong></td>
<td></td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments</td>
<td>1</td>
</tr>
</tbody>
</table>

**ESSENTIAL READING**

SFRS(I) 1-40 Investment Property, SFRS(I) 13 Fair Value Measurement, SFRS(I) 1-20 Accounting for Government Grants and Disclosure of Government Assistance, INT FRS 10 Government Assistance – No Specific Relation to Operating Activities

1 **SFRS(I) 1-40 Investment Property**

**SECTION INTRODUCTION**

SFRS(I) 1-40 was developed in order to provide more relevant information to users of the financial statements in respect of investment properties. The standard provides a detailed definition of an investment property, together with examples of investment property.

An entity may own land or a building as an investment rather than for use in the business. It may therefore generate cash flows largely independently of other assets which the entity holds.

Prior to the development of IAS 40 (SFRS(I) 1-40) Investment Property in 2000, there was no separate accounting guidance applicable to these investment properties. Many commentators felt that such properties should fall within the scope of IAS 16 (SFRS(I) 1-16) Property, Plant and Equipment, however the International Accounting Standards Committee (IASC) decided that the characteristics of investment property differ sufficiently from those of owner-occupied property to merit a separate standard. In particular, the IASC felt that information about the fair value of investment property is highly relevant to users of financial information.
1.1 Definitions

SFRS(I) 1-40 provides definitions of both investment and owner-occupied property, as well as other relevant terms:

**KEY TERMS**

**INVESTMENT PROPERTY** is property (land or a building – or part of a building – or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

(a) Use in the production or supply of goods or services or for administrative purposes, or
(b) Sale in the ordinary course of business

**OWNER-OCCUPIED PROPERTY** is property held by the owner (or by the lessee as a right-of-use asset) for use in the production or supply of goods or services or for administrative purposes.

**FAIR VALUE** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**COST** 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.

**CARRYING AMOUNT** is the amount at which an asset is recognised in the statement of financial position.

1.2 Examples of investment property

For the avoidance of doubt, SFRS(I) 1-40 provides examples of property which is investment property and examples of property which is not investment property. SFRS(I) 1-40 must be applied to all properties which meet the definition of investment property.

**Examples** of investment property include:

(a) Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business
(b) A building owned by the reporting entity (or a right-of-use asset relating to a building held by the entity) and leased out under one or more operating leases
(c) Property being constructed or developed for future use as investment property

**Question 8.1**

(Investment property)

(a) Geylang Electrical owns a piece of land. The directors have not yet decided whether to build a factory on it for use in its business or to keep it and sell it when its value has risen.
(b) Somerset Trading owns a building which is currently vacant. The company intends to lease each floor of the building out under a separate operating lease.
(c) Somerset Trading also owns a building which it leases to its subsidiary company, Devon Lighting.

Would these be classified as investment properties under SFRS(I) 1-40?

1.2.1 Property which is not investment property

You now know what an investment property under SFRS(I) 1-40 is. Below are examples of items that are not investment property.
### Type of non-investment property

| Property held for sale in the ordinary course of business or in the process of development or construction for such sale. | SFRS(I) 1-2 Inventories |
| Owner-occupied property including owner-occupied property awaiting disposal | SFRS(I) 1-16 Property, Plant and Equipment |
| Property that is leased to another entity under a finance lease | SFRS(I) 16 Leases |

The measurement provisions of SFRS(I) 5 Non-current Assets Held for Sale and Discontinued Operations do not apply to non-current assets that are accounted for in accordance with the fair value model in SFRS(I) 1-40.

### Example

Jurong Pte Ltd is a training organisation which operates from a site on the outskirts of Singapore. The company owns a number of apartments on site which are let to members of Jurong staff at market rates.

Are these apartments investment property?

### Solution

No, property occupied by employees is owner-occupied property. This is regardless of whether the employees pay rent at market rates.

### 1.3 Dual-use property

In some cases one property is partly used by an entity and partly held by the entity as an investment property. In this case the property is classified as follows:

(a) If the two portions of the property could be sold separately or leased out separately under a finance lease, the property is split with the owner-occupied portion accounted for under SFRS(I) 1-16 and the investment property portion under SFRS(I) 1-40.

(b) If the two portions could not be sold separately:

(i) The property is treated as owner-occupied if a significant portion is held for own use

(ii) The property is treated as investment property only if an insignificant portion is held for own use
1.4 Ancillary services

An entity may provide ancillary services to the occupants of a property, for example maintenance. Where such services are provided:

(a) The property is treated as investment property where the supply of ancillary services is insignificant to the arrangement as a whole

(b) The property is treated as owner-occupied where the services are significant

Example

W Ltd is a diversified company with a property portfolio which includes the following:

(a) A hotel which is owned and managed by the company

(b) An office building which it owns and leases out to a number of parties. W Ltd provides a concierge service and a repairs and maintenance service

Do these properties meet the definition of investment property?

Solution

(a) The hotel is considered owner-occupied so it is not classified as an investment property. This is because services such as a receptionist, concierge and housekeeping are considered significant to the arrangement.

(b) The office building is treated as investment property since the concierge and repairs and maintenance services are not significant to the arrangement as a whole.
Example

Dodds Ltd acquired a property by way of a 20 year lease on 1 August 20X3. The company split the property into 30 units and immediately began to market each separate floor to small businesses as available to let on short-term leases. By the end of November just six units had been sublet and as an incentive to attract more tenants, Dodds offered to provide certain services to its tenants. These services included security, maintenance, a central reception function and a secretarial function. These services were extended to the existing tenants. This is a departure from the normal business model of Dodds Ltd and required the company to recruit a number of staff to work at the property and occupy two of the empty units. By the year-end of 31 December 20X3, a further 10 units had been sublet.

Discuss whether the property is an investment property.

Solution

An investment property is property which is held to earn rentals or for capital appreciation or both rather than for use in the production or supply of goods or services or for administrative purposes or for sale in the ordinary course of business.

The property is held as a right-of-use asset under a lease in accordance with SFRS(I) 16; this is not relevant to its possible classification as an investment property as SFRS(I) 1-40 does not require an investment property to be owned.

The property is available to let under short-term (operating) leases, and therefore meets the basic definition of an investment property.

From 1 August 20X3 to the end of November the 30 individual units are either let or available to let without the provision of any ancillary services. Therefore for this time the property is classified as investment property.

From the end of November to 31 December 20X3, ancillary services are provided to all existing and prospective tenants. The question is whether these ancillary services are significant to the arrangement as a whole. If they are, then the property is classified as owner-occupied; if they are not then the property is classified as investment property.

Based on the information, the services provided appear to be significant. Dodds Ltd is required to recruit a number of additional staff and certain services provided are core to the operation of tenants' businesses. Therefore it should be concluded that the property is owner–occupied from the end of November and it should be accounted for in accordance with SFRS(I) 1-16 Property, Plant and Equipment.

1.5 Use of judgment

Although SFRS(I) 1-40 clearly defines investment property, and provides a number of examples of investment property, the classification of more complex arrangements involving ancillary services and dual-use of property will require the application of judgment. SFRS(I) 1-40 states that an entity should develop criteria within the requirements of the standard so that it can exercise that judgment consistently. The standard also requires that these criteria are disclosed where classification is difficult.

1.6 The acquisition of investment property

SFRS(I) 1-40 clarifies that when property is acquired, a company must use judgment to assess whether the transaction is the acquisition of an asset, a group of assets or a business combination. Whilst SFRS(I) 1-40 is applied in order to judge whether an owner-occupied or investment property has been acquired, SFRS(I) 3 Business Combinations must be applied in order to determine whether the transaction is a business combination.
SECTION SUMMARY

SFRS(I) 1-40 *Investment Property* defines investment property as property *held to earn rentals or for capital appreciation* or both, rather than for:

- Use in production or supply of goods or services
- Sale in the ordinary course of business

The definition includes land held for an undetermined use, a building leased out under operating leases and property which is being developed for use as investment property.

2 Recognition and initial measurement

SECTION INTRODUCTION

The recognition criteria of SFRS(I) 1-40 are in line with those stated in the *Conceptual Framework*. The standard also provides guidance on the initial measurement of an investment property.

2.1 Recognition

Owned investment property should be recognised as an asset when, and only when *two conditions* are met:

(a) It is *probable* that the *future economic benefits* that are associated with the investment property will *flow to the entity*.

(b) The cost of the investment property can be *measured reliably*.

An investment property held by a lessee as a right-of-use asset is recognised in accordance with SFRS(I) 16.

2.2 Initial measurement

An owned investment property should be measured initially at its *cost*, including transaction costs.

Cost includes purchase price and directly attributable expenditure such as professional fees for legal services and property transfer taxes.

It does not include start-up costs, operating losses incurred before the planned level of occupancy is achieved or abnormal costs incurred in construction or development of the property.

2.2.1 Investment property which is leased

An investment property that is held by a lessee as a right-of-use asset is initially measured at its cost in accordance with SFRS(I) 16. The right-of-use asset is recognised at the amount of the lease liability plus any initial direct costs, any payments already made and the present value of future restoration costs, less lease incentives received. The lease liability is measured at the present value of the future lease payments. Any premium paid for the lease is part of the measurement of the right-of-use asset but is excluded from the lease liability.
2.2.2 Exchange transactions

Where an investment property is acquired in exchange for another asset, the property is initially measured at **fair value** assuming that:

(a) The transaction is commercial
(b) The fair value of either the property acquired or exchanged asset can be measured reliably

If the fair value of the property acquired or exchanged asset cannot be established, the investment property is measured at the carrying amount of the exchanged asset.

### SECTION SUMMARY

An investment property is recognised when it is probable that future economic benefits will flow to an entity and the cost can be measured reliably. The property is initially measured at cost including transaction costs.

3 Subsequent measurement

### SECTION INTRODUCTION

SFRS(I) 1-40 allows a choice of accounting models to be applied to investment property: the cost model or the fair value model.

SFRS(I) 1-40 requires an entity to choose as its accounting policy for investment properties either:

- The fair value model; or
- The cost model.

Whichever policy is chosen must be applied to **all of the entity's investment properties**, including those held as right-of-use assets.

#### 3.1 Fair value model

The fair value model is not the same as the revaluation model, where increases in carrying amount above a cost-based measure are recognised as a revaluation surplus. Under the fair value model all changes in fair value are recognised in profit or loss.

Therefore where the fair value model is applied to investment property:

(a) The asset is measured in the statement of financial position at the reporting date at its fair value
(b) Changes in fair value are recognised in profit or loss in the period in which they arise

### Example

Prosperity Consumables Ltd acquired an investment property in Chiang Mai, Thailand, on 12 April 20X8 at a cost of 100 million Thai baht (THB). The fair value of the property was THB115 million at the year-end of 31 October 20X8.

What amounts are reported in Prosperity Consumable's financial statements in respect of this property at 31 October 20X8 assuming that the company applies the SFRS(I) 1-40 fair value model?
Exchange rates:

<table>
<thead>
<tr>
<th>Date</th>
<th>THB 1:</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>12 April 20X8</td>
<td>0.045</td>
<td></td>
</tr>
<tr>
<td>31 October 20X8</td>
<td>0.042</td>
<td></td>
</tr>
</tbody>
</table>

**Solution**

The property is initially recognised at $4.5 million (100m × 0.045) ($'000):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Investment property</th>
<th>4,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit</td>
<td>Cash</td>
<td>4,500</td>
</tr>
</tbody>
</table>

to record the purchase of investment property in Thailand

At the year-end the property is re-measured to fair value, and in accordance with SFRS(I) 1-21, translated using the exchange rate at the date when fair value is measured. Therefore the property is re-measured to $4.83 million (115m × 0.042). The $330,000 increase in value of the property is in part due to the fair value increase and in part due to the move in exchange rates:

<table>
<thead>
<tr>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value increase: 15m × 0.042</td>
</tr>
<tr>
<td>Exchange loss: (100m × 0.045) – (100m × 0.042)</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

These elements are recognised separately in profit or loss ($'000):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Investment property</th>
<th>330</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit</td>
<td>Exchange loss (profit or loss)</td>
<td>300</td>
</tr>
<tr>
<td>Credit</td>
<td>Increase in fair value of investment property (profit or loss)</td>
<td>630</td>
</tr>
</tbody>
</table>

to re-measure the investment property to fair value and recognise the corresponding fair value gain and exchange loss

3.1.1 Application to investment property held as a right-of-use asset

Where an investment property is held as a right-of-use asset, it is the right-of-use asset rather than the underlying property that is measured at fair value.

Where lease payments are at market rates, the fair value of an investment property held as a right-of-use asset net of all expected lease payments should be nil. Therefore remeasurement to fair value will only result in a gain or loss where fair value is measured at different times eg when the fair value model is adopted after initial recognition.

3.1.2 Application of the fair value model

An entity that chooses the fair value model must measure all of its investment property at fair value, except in the extremely rare cases where this cannot be measured reliably. In such cases the entity should apply the SFRS(I) 1-16 cost model to the property for which a reliable measurement is not available, whilst applying the fair value model to its other properties.

SFRS(I) 1-40 states that a reliable fair value cannot be established when, and only when, the market for comparable properties is inactive (ie there are few recent transactions), price quotations are not current or observed transaction prices indicate that the seller was forced to sell and alternative reliable measurements of fair value (such as discounted cash flow projections) are not available. There is a rebuttable presumption that fair value can be measured reliably on a continuing basis.

Where an entity which applies the fair value model has property under construction, for which the fair value cannot be measured reliably due to its incomplete state, that property is measured at cost. The fair value model is applied to the property at the earlier of the date on which fair value can be established reliably or it is complete.
3.1.3 Establishing fair value

As a result of the issue of SFRS(I) 13 Fair Value Measurement, much of the guidance provided in SFRS(I) 1-40 in respect of the determination of fair value was deleted. Instead the requirements of SFRS(I) 13 (see Chapter 3) apply in measuring the fair value of investment properties. SFRS(I) 13 requires that the following are considered in determining fair value of investment properties or related right-of-use assets:

(a) The asset being measured
(b) The principal market (ie that where the most activity takes place) or where there is no principal market, the most advantageous market (ie that in which the best price could be achieved) in which an orderly transaction would take place for the asset
(c) The highest and best use of the asset and whether it is used on a stand-alone basis or in conjunction with other assets
(d) Assumptions that market participants would use when pricing the asset

Having considered these factors, SFRS(I) 13 provides a hierarchy of inputs for arriving at fair value. It requires that level 1 inputs are used where possible:

Level 1 Quoted prices (unadjusted) in active markets for identical assets that the entity can access at the measurement date
Level 2 Inputs other than quoted prices that are directly or indirectly observable for the asset
Level 3 Unobservable inputs for the asset

Level 1 inputs are prices quoted in active markets for items identical to the asset (in this case investment property) being measured. Active markets are ones where transactions take place with sufficient frequency and volume for pricing information to be provided.

In general, SFRS(I) 13 requires in respect of non-financial assets that fair value is decided on the basis of the highest and best use of the asset as determined by a market participant. Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. For example, an entity may intend to use assets acquired in a business combination differently from how other market participants might use them. If, however, there is no evidence to suggest that the current use of an asset is not its highest and best use an entity does not need to carry out an exhaustive search for other potential uses.

3.1.4 Assets related to the investment property

The guidance which remains in SFRS(I) 1-40 in respect of establishing the fair value of an investment property requires that assets or liabilities which are part of the investment property are not double counted:

(a) Equipment such as lifts or air conditioning, which form an integral part of a building, should be included in the fair value of the investment property rather than recognised separately.
(b) If an office is leased on a furnished basis, the furniture should be included in the fair value of the investment property rather than recognised as a separate asset.

3.2 Cost model

Where the cost model is adopted, investment properties are measured as follows:

(a) In accordance with SFRS(I) 5 if the property meets the criteria to be classified as held for sale;
(b) In accordance with SFRS(I) 16 if the property is held by a lessee as a right-of-use asset (and is not classified as held for sale); and
(c) In accordance with the SFRS(I) 1-16 cost model in all other cases.
3.3 Changing models

An entity must apply either the cost or the fair value model consistently. It should not change from one model to the other unless the change will result in a more appropriate presentation. SFRS(I) 1-40 states that it is highly unlikely that a change from the fair value model to the cost model will result in a more appropriate presentation.

3.4 Comparison between SFRS(I) 1-16 and SFRS(I) 1-40 measurement rules

<table>
<thead>
<tr>
<th>SFRS(I) 1-16 Property, Plant and Equipment</th>
<th>SFRS(I) 1-40 Investment Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>For own use</td>
<td>For investment purposes</td>
</tr>
<tr>
<td>Cost model</td>
<td>Cost model</td>
</tr>
<tr>
<td>Historical cost less accumulated depreciation less accumulated impairment</td>
<td>Historical cost less accumulated depreciation less accumulated impairment</td>
</tr>
<tr>
<td>Revaluation model</td>
<td>Revaluation model</td>
</tr>
<tr>
<td>Fair value less accumulated depreciation less accumulated impairment with movements in fair value recognised in OCI unless they reverse an amount previously recognised in profit or loss.</td>
<td>Fair value model</td>
</tr>
<tr>
<td></td>
<td>Fair value with movements in fair value recognised in profit or loss.</td>
</tr>
</tbody>
</table>

SECTION SUMMARY

An entity’s investment properties are all measured using either the fair value or the cost model. Under the fair value model the properties (or related right-of-use assets) are measured at fair value in accordance with SFRS(I) 13 and any gains or losses are recognised in profit or loss. Under the cost model, the cost model of SFRS(I) 1-16 is applied. An entity should not change from one model to another unless it results in a more appropriate presentation.

4 Transfers

SECTION INTRODUCTION

A change in the use of a property may mean that it is transferred to or from investment property.

A change in use occurs when:

(a) A property meets or ceases to meet the definition of investment property; and
(b) There is evidence of a change in use.

A change in management intentions regarding the use of a property does not alone provide evidence of a change in use.
SFRS(I) 1-40 provides two examples of transfers to investment property and two examples of transfers from investment property, however these are not exhaustive and other situations could result in a transfer:

<table>
<thead>
<tr>
<th>Transfers to investment property</th>
<th>Transfers from investment property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner-occupation ceases (SFRS(I) 1-16 to SFRS(I) 1-40)</td>
<td>Investment property becomes owner-occupied or development commences with a view to owner-occupation (SFRS(I) 1-40 to SFRS(I) 1-16)</td>
</tr>
<tr>
<td>The inception of an operating lease to another party for property previously held as inventory (FRS 2 to SFRS(I) 1-40)</td>
<td>Development of investment property commences with a view to a sale (SFRS(I) 1-40 to SFRS(I) 1-2)</td>
</tr>
</tbody>
</table>

### 4.1 Accounting treatment

When there is a transfer from investment property carried at fair value to owner-occupied property or inventories, the property's cost for subsequent accounting under SFRS(I) 1-16 or SFRS(I) 1-2 should be its fair value at the date of change of use.

When there is a transfer from owner-occupied property carried at depreciated cost to investment property carried at fair value, SFRS(I) 1-16 should be applied up to the date of change of use. Any difference between carrying amount under the cost model and fair value at the date of change in use is treated a revaluation under SFRS(I) 1-16.

When there is a transfer from inventories to investment property carried at fair value, any difference between the fair value of a property and its previous carrying amount is recognised in profit or loss.
Example

Orchard Flowers Pte Ltd (OFPL) purchased a property several years ago, and until 1 June 20X1 used it as a head office. Depreciation of $150,000 was charged in respect of the property, in the five months to 31 May 20X1. At that date the property had a carrying amount of $5.5 million and a market value of $8 million. On 1 June 20X1, OFPL relocated its head office to a different location, and immediately began refurbishment work in order to develop the old head office for future rental income. The fair value of the property at the year-end of 31 December 20X1 was $8.2 million. The company uses the fair value model to measure investment properties.

(a) What accounting entries are required on the date when the property ceases to be owner-occupied?

(b) What amounts are reported in the financial statements in respect of the property in the year ended 31 December 20X1?

Solution

Until June 20X1 the property served as OFPL’s head office, and therefore until this date it would have been recognised and measured in accordance with SFRS(I) 1-16 Property, Plant and Equipment at a carrying amount of $5.5 million.

In June 20X1 there was a change in use of the property evidenced by the fact that it ceased to be owner-occupied and work began to develop the property to lease out to tenants. As the property is under development for future rental income, it meets the criteria to be recognised as an investment property. SFRS(I) 1-40 states that property that is being constructed or developed for future use as investment property should be classified as investment property.

SFRS(I) 1-16 is applied up to the date of change of use when an owner-occupied property is transferred to investment property, and immediately prior to the transfer the property is revalued to its fair value of $8 million ($’000):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Property, plant and equipment (at carrying amount)</th>
<th>2,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Other comprehensive income</td>
<td>2,500</td>
</tr>
</tbody>
</table>

to recognise a revaluation of the property to fair value

The property is then transferred to investment property by ($’000):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Investment property</th>
<th>8,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Property, plant and equipment</td>
<td>8,000</td>
</tr>
</tbody>
</table>

to transfer the property to investment property

At the year-end the property is re-measured to fair value in accordance with SFRS(I) 1-40 ($’000):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Investment property</th>
<th>200</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Profit or loss</td>
<td>200</td>
</tr>
</tbody>
</table>

to re-measure investment property to fair value

Therefore amounts reported in the financial statements for the year ended 31 December 20X1 are:

<table>
<thead>
<tr>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of financial position</td>
</tr>
<tr>
<td>Investment properties</td>
</tr>
<tr>
<td>Statement of profit or loss</td>
</tr>
<tr>
<td>Depreciation expense</td>
</tr>
<tr>
<td>Change in the fair value of investment properties</td>
</tr>
<tr>
<td>Other comprehensive income</td>
</tr>
<tr>
<td>Gain on property revaluation</td>
</tr>
</tbody>
</table>
### SECTION SUMMARY

Where a property is transferred from investment property carried at fair value its carrying amount at the date of transfer is treated as cost; where owner-occupied property is transferred to investment property carried at fair value it is revalued prior to the transfer; where inventories are transferred to investment property carried at fair value any gain or loss is recognised in profit or loss.

### 5 Disposals

#### SECTION INTRODUCTION

An investment property is derecognised on disposal or when it is permanently withdrawn from use and no future economic benefits are expected from its disposal.

Any **gain or loss** on disposal is the difference between the net disposal proceeds and the carrying amount of the asset. It should generally be **recognised as income or expense in profit or loss**.

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

#### Example

X Ltd purchased an investment property on 1 April 20X4 for $11.2 million. The property has a useful life of 50 years with no residual value. On 31 March 20X7 the property had a fair value on $13.6 million. The property was sold for net proceeds of $13.2 million on 1 April 20X7.

What is the profit or loss on disposal assuming:

(a) The cost model is adopted  
(b) The fair value model is adopted

#### Solution

<table>
<thead>
<tr>
<th>(a) Cost model</th>
<th>$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>13.2</td>
</tr>
<tr>
<td>Carrying amount (11.2 x 47/50)</td>
<td>10.5</td>
</tr>
<tr>
<td><strong>Profit on disposal (profit or loss)</strong></td>
<td><strong>2.7</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(b) Fair value model</th>
<th>$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>13.2</td>
</tr>
<tr>
<td>Fair value</td>
<td>13.6</td>
</tr>
<tr>
<td><strong>Loss on disposal (profit or loss)</strong></td>
<td><strong>(0.4)</strong></td>
</tr>
</tbody>
</table>

SFRS(I) 1-40 also states that where an entity recognises the cost of a replacement part of an investment property in its carrying amount, it should derecognise the carrying amount of the part which is replaced.
**Example**

X Ltd is an investment property company. It uses the fair value model for investment properties. One of its properties, site B, has a refrigeration plant. The refrigeration system is an integral part of the building. The refrigeration system was purchased on 1 January 20X0 for $192,000. It is being depreciated on a straight-line basis over 10 years (with no residual value). The carrying amount of the refrigeration system has been included in the fair value of Site B, on agreement with the valuer that this is a reasonable value to use.

In December 20X5 the fair of value of Site B, including the refrigeration system was estimated to be $3,000,000. On 28 December 20X5, however, the refrigeration system broke down and could not be repaired. It was scrapped immediately and was replaced on 31 December 20X5 with a new system costing $336,000.

What is the fair value of Site B at 31 December 20X5?

**Solution**

$3,000,000 – ($192,000 × 4/10) + 336,000 = $3,259,200

**SECTION SUMMARY**

On disposal of an investment property, the difference between proceeds and carrying amount of the property is recognised in profit or loss.

### 6 Disclosure requirements

**SECTION INTRODUCTION**

SFRS(I) 1-40 requires certain disclosures for all investment properties, with additional requirements depending on whether the cost model or fair value model is applied.

Disclosures in respect of investment properties relate to:

- Choice of fair value model or cost model
- Criteria for classification as investment property
- Extent to which fair value is based on independent professional valuer
- Rental income and expenses
- Any restrictions or obligations

**6.1 Fair value model – additional disclosures**

An entity that adopts the fair value model must provide additional disclosures including the following:

(a) A **reconciliation** of the carrying amount of the investment property at the beginning and end of the period.
(b) Where the fair value model is adopted but fair value of a property cannot be measured the following should be disclosed:

(i) A description of the property
(ii) An explanation of why fair value cannot be measured reliably
(iii) The range of estimates within which fair value is expected to lie (if possible)
(iv) Details of any disposal

Example

The following extract is taken from CapitaLand Ltd Annual Report 2017.


5 INVESTMENT PROPERTIES

<table>
<thead>
<tr>
<th></th>
<th>The Group 2017</th>
<th>The Group 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>At 1 January</td>
<td>18,998,389</td>
<td>19,427,532</td>
</tr>
<tr>
<td>Acquisition of subsidiaries</td>
<td>17,565,394</td>
<td>54,446</td>
</tr>
<tr>
<td>Disposal of a subsidiary</td>
<td>(235,804)</td>
<td>(966,635)</td>
</tr>
<tr>
<td>Additions</td>
<td>2,174,208</td>
<td>726,653</td>
</tr>
<tr>
<td>Disposals</td>
<td>(1,787,933)</td>
<td>(79,318)</td>
</tr>
<tr>
<td>Reclassification to assets held for sale</td>
<td>(438,368)</td>
<td>–</td>
</tr>
<tr>
<td>Reclassification from/(to) development properties for sale</td>
<td>49,078</td>
<td>(95,263)</td>
</tr>
<tr>
<td>Changes in fair value</td>
<td>234,978</td>
<td>290,707</td>
</tr>
<tr>
<td>Translation differences</td>
<td>(80,508)</td>
<td>(359,733)</td>
</tr>
<tr>
<td>At 31 December</td>
<td>36,479,434</td>
<td>18,998,389</td>
</tr>
</tbody>
</table>

(a) Investment properties, which include those in the course of development are stated at fair value based on independent professional valuations or internal valuations. The fair values are based on open market values, being the estimated amount for which a property could be exchanged on the date of the valuation between a willing buyer and a willing seller in an arm's length transaction wherein the parties had each acted knowledgeably and without compulsion. In determining the fair value, the valuers have used valuation techniques which involve certain estimates. The key assumptions used to determine the fair value of investment properties include market-corroborated capitalisation yield, terminal yield rate and discount rate. In relying on the valuation reports, management has exercised its judgement and is satisfied that the valuation methods and estimates are reflective of current market conditions.

The valuers have considered valuation techniques including the direct comparison method, capitalisation approach, discounted cash flows and residual method in arriving at the open market value as at the balance sheet date. The direct comparison method involves the analysis of comparable sales of similar properties and adjusting the sale prices to that reflective of the investment properties. The capitalisation approach capitalises an income stream into a present value using revenue multipliers or single-year capitalisation rates. The discounted cash flow method involves the estimation and projection of an income stream over a period and discounting the income stream with an internal rate of return to arrive at the market value. In the residual method of valuation, the total gross development costs and developer's profit are deducted from the gross development value to arrive at the residual value of land. The gross development value is the estimated value of the property assuming satisfactory completion of the development as at the date of valuation. Details of valuation methods and key assumptions used to estimate the fair values of investment properties are set out in note 34.
The Group's investment properties which are classified under Level 3 are analysed as below:

<table>
<thead>
<tr>
<th>Shopping malls</th>
<th>Commercial and integrated developments</th>
<th>Serviced residences</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$’000</td>
<td>$’000</td>
<td>$’000</td>
<td>$’000</td>
</tr>
<tr>
<td>The Group 2017</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>9,538,000</td>
<td>12,121,826</td>
<td>950,156</td>
</tr>
<tr>
<td>China (includes Hong Kong)</td>
<td>3,134,608</td>
<td>1,957,898</td>
<td>1,499,798</td>
</tr>
<tr>
<td>Others*</td>
<td>2,080,936</td>
<td>1,176,730</td>
<td>4,019,482</td>
</tr>
<tr>
<td></td>
<td><strong>14,753,544</strong></td>
<td><strong>15,256,454</strong></td>
<td><strong>7,277,148</strong></td>
</tr>
<tr>
<td>2016</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>1,340,000</td>
<td>6,483,387</td>
<td>958,002</td>
</tr>
<tr>
<td>China (includes Hong Kong)</td>
<td>1,018,175</td>
<td>1,583,685</td>
<td>1,580,214</td>
</tr>
<tr>
<td>Others*</td>
<td>1,962,990</td>
<td>204,556</td>
<td>3,867,380</td>
</tr>
<tr>
<td></td>
<td><strong>4,321,165</strong></td>
<td><strong>8,271,628</strong></td>
<td><strong>6,405,596</strong></td>
</tr>
</tbody>
</table>

* Others include countries in Asia (excluding Singapore, China and Hong Kong), Europe, United States of America and Australia.

(c) As at 31 December 2017, investment properties valued at $1,693.8 million (2016: $1,075.5 million) were under development.

(d) As at 31 December 2017, certain investment properties with carrying value of approximately $10,088.9 million (2016: $10,196.3 million) were mortgaged to banks to secure credit facilities (notes 19 and 20) and under finance lease arrangements for the Group.

(e) During the financial year ended 31 December 2017, interest capitalised as cost of investment properties amounted to approximately $29.0 million (2016: $21.0 million) (note 27(d)).

(f) Investment properties of the Group are held mainly for use by tenants under operating leases. Minimum lease payments receivable under non-cancellable operating leases of investment properties and not recognised in the financial statements are as follows:

<table>
<thead>
<tr>
<th>Lease rentals receivable:</th>
<th>2017</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$’000</td>
<td>$’000</td>
</tr>
<tr>
<td>Not later than 1 year</td>
<td>1,601,121</td>
<td>616,212</td>
</tr>
<tr>
<td>Between 1 and 5 years</td>
<td>2,452,180</td>
<td>993,188</td>
</tr>
<tr>
<td>After 5 years</td>
<td>1,259,362</td>
<td>98,537</td>
</tr>
<tr>
<td></td>
<td><strong>5,312,663</strong></td>
<td><strong>1,707,937</strong></td>
</tr>
</tbody>
</table>

(g) Contingent rents, representing income based on sales turnover achieved by tenants, amounted to $78.7 million for the year (2016: $16.7 million)
6.2 Cost model – additional disclosures

Additional disclosures required where the cost model is adopted relate mainly to the depreciation policy. In addition, an entity which adopts the cost model must disclose:

- A reconciliation of carrying amount at the start and end of the period
- The fair value of the investment property

**SECTION SUMMARY**

Disclosures relate to classification as investment property and which measurement model is applied. A reconciliation of carrying amount at the start and end of the period is required regardless of the measurement model adopted; where the cost model is applied additional disclosures are required in respect of depreciation and fair value; where the fair value model is applied but the fair value of a property cannot be measured reliably, details must be given.

7 SFRS(I) 1-20 Accounting for Government Grants and Disclosure of Government Assistance

**SECTION INTRODUCTION**

Entities may receive government grants for various purposes (grants may be referred to as subsidies, premiums etc). They may also receive other types of assistance.

7.1 Scope

The accounting treatment of government grants is covered by SFRS(I) 1-20 Accounting for Government Grants and Disclosure of Government Assistance. SFRS(I) 1-20 does not cover the following situations.

- Accounting for government grants in financial statements reflecting the effects of changing prices
- Government assistance given in the form of ‘tax benefits’
- Government acting as part-owner of the entity
- Government grants covered by SFRS(I) 1-41 Agriculture
7.2 Definitions

These definitions are given by the standard.

**KEY TERMS**

**GOVERNMENT** Government, government agencies and similar bodies whether local, national or international.

**GOVERNMENT ASSISTANCE** Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. Government assistance for the purpose of this Standard does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or in the imposition of trading constraints on competitors.

**GOVERNMENT GRANTS** Assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

**GRANTS RELATED TO ASSETS** Government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire non-current assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

**GRANTS RELATED TO INCOME** Government grants other than those related to assets.

**FORGIVABLE LOANS** Loans for which the lender undertakes to waive repayment under certain prescribed conditions.

**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.

You can see that there are many different forms of government assistance: both the type of assistance and the conditions attached to it will vary. Government assistance may have encouraged an entity to undertake something it otherwise would not have done.

How will the receipt of government assistance affect the financial statements?

(a) An appropriate method must be determined to account for any resources transferred.

(b) The extent to which an entity has benefited from such assistance during the reporting period should be shown.

7.3 Recognition criteria

An entity should not recognise government grants (including non-monetary grants at fair value) until it has reasonable assurance that:

- The entity will comply with any conditions attached to the grant
- The entity will actually receive the grant

Even if the grant has been received, this does not prove that the conditions attached to it have been or will be fulfilled.

It makes no difference in the treatment of the grant whether it is received in cash or given as a reduction in a liability to government, ie the manner of receipt is irrelevant.
Any related contingency should be recognised under SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets, once the grant has been recognised.

In the case of a forgivable loan (as defined in key terms above) from government, it should be treated in the same way as a government grant when it is reasonably assured that the entity will meet the relevant terms for forgiveness.

### 7.3.1 Recognition of government grants

SFRS(I) 1-20 requires that grants are recognised as income over the relevant periods to match them with related costs which they have been received to compensate. This should be done on a systematic basis. Grants should not, therefore, be credited directly to equity.

It would be against the accruals assumption to credit grants to income on a receipts basis, so a systematic basis of matching must be used. A receipts basis would only be acceptable if no other basis was available.

It will usually be easy to identify the costs related to a government grant, and thereby the period(s) in which the grant should be recognised as income, ie when the costs are incurred. Where grants are received in relation to a depreciating asset, the grant will be recognised over the periods in which the asset is depreciated and in the same proportions.

#### Example

A Ltd receives a government grant representing 50% of the cost of a depreciating asset which costs $40,000. How will the grant be recognised if A Ltd depreciates the asset:

(a) Over four years straight line; or
(b) At 40% reducing balance?

The residual value is nil. The useful life is four years.

#### Solution

The grant should be recognised in the same proportion as the depreciation.

(a) Straight line

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation $</th>
<th>Grant income $</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10,000</td>
<td>5,000</td>
</tr>
<tr>
<td>2</td>
<td>10,000</td>
<td>5,000</td>
</tr>
<tr>
<td>3</td>
<td>10,000</td>
<td>5,000</td>
</tr>
<tr>
<td>4</td>
<td>10,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

(b) Reducing balance

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation $</th>
<th>Grant income $</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>16,000</td>
<td>8,000</td>
</tr>
<tr>
<td>2</td>
<td>9,600</td>
<td>4,800</td>
</tr>
<tr>
<td>3</td>
<td>5,760</td>
<td>2,880</td>
</tr>
<tr>
<td>4 (remainder)</td>
<td>8,640</td>
<td>4,320</td>
</tr>
</tbody>
</table>
In the case of grants for non-depreciable assets, certain obligations may need to be fulfilled, in which case the grant should be recognised as income over the periods in which the cost of meeting the obligation is incurred. For example, if a piece of land is granted on condition that a building is erected on it, then the grant should be recognised as income over the building's life.

There may be a series of conditions attached to a grant, in the nature of a package of financial aid. An entity must take care to identify precisely those conditions which give rise to costs which in turn determine the periods over which the grant will be earned. When appropriate, the grant may be split and the parts allocated on different bases.

An entity may receive a grant as compensation for expenses or losses which it has already incurred. Alternatively, a grant may be given to an entity simply to provide immediate financial support where no future related costs are expected. In cases such as these, the grant received should be recognised as income of the period in which it becomes receivable.

7.3.2 Measurement of non-monetary government grants
A non-monetary asset may be transferred by government to an entity as a grant, for example a piece of land, or other resources. The fair value of such an asset is usually assessed and this is used to account for both the asset and the grant. Alternatively, both may be valued at a nominal amount.

7.4 Presentation of grants
7.4.1 Presentation of grants related to assets
There are two choices for how government grants related to assets (including non-monetary grants at fair value) should be shown in the statement of financial position.

<table>
<thead>
<tr>
<th>Grants related to assets</th>
<th>Choice of presentation:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognise grant as deferred income</td>
<td>Deduct from carrying amount of asset</td>
</tr>
<tr>
<td>Recognise credit in profit or loss as grant is released</td>
<td>Depreciation charge is reduced as grant is released to profit or loss</td>
</tr>
</tbody>
</table>

These are considered to be acceptable alternatives and we can look at an example showing both.

**Example**
A company receives a 20% grant towards the cost of a new item of machinery, which cost $100,000. The machinery has an expected life of four years and a nil residual value. The expected profits of the company, before accounting for depreciation on the new machine or the grant, amount to $50,000 per annum in each year of the machinery's life. How is the grant recognised?

(a) If it is deducted from the carrying amount of the asset
(b) If it is presented as deferred income.
Solution

The results of the company for the four years of the machine's life would be as follows.

(a) Reducing the cost of the asset

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Profit before depreciation</td>
<td>50,000</td>
<td>50,000</td>
<td>50,000</td>
<td>50,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Depreciation*</td>
<td>(20,000)</td>
<td>(20,000)</td>
<td>(20,000)</td>
<td>(20,000)</td>
<td>(80,000)</td>
</tr>
<tr>
<td>Profit</td>
<td>30,000</td>
<td>30,000</td>
<td>30,000</td>
<td>30,000</td>
<td>120,000</td>
</tr>
</tbody>
</table>

*The depreciation charge on a straight line basis, for each year, is \(\frac{1}{4}\) of \$(100,000 - 20,000) = \$20,000.

Statement of financial position at year-end (extract)

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current asset</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>Accum. depreciation</td>
<td>(20,000)</td>
<td>(40,000)</td>
<td>(60,000)</td>
<td>(80,000)</td>
<td></td>
</tr>
<tr>
<td>Carrying amount</td>
<td>60,000</td>
<td>40,000</td>
<td>20,000</td>
<td>–</td>
<td></td>
</tr>
</tbody>
</table>

(b) Treating the grant as deferred income

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Profit as above</td>
<td>50,000</td>
<td>50,000</td>
<td>50,000</td>
<td>50,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(25,000)</td>
<td>(25,000)</td>
<td>(25,000)</td>
<td>(25,000)</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Grant</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Profit</td>
<td>30,000</td>
<td>30,000</td>
<td>30,000</td>
<td>30,000</td>
<td>120,000</td>
</tr>
</tbody>
</table>

Statement of financial position at year-end (extract)

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current asset</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Accum. depreciation</td>
<td>(25,000)</td>
<td>(50,000)</td>
<td>(75,000)</td>
<td>(100,000)</td>
<td></td>
</tr>
<tr>
<td>Carrying amount</td>
<td>75,000</td>
<td>50,000</td>
<td>25,000</td>
<td>–</td>
<td></td>
</tr>
<tr>
<td>Government grant deferred income</td>
<td>15,000</td>
<td>10,000</td>
<td>5,000</td>
<td>–</td>
<td></td>
</tr>
</tbody>
</table>

Whichever of these methods is used, the cash flows in relation to the purchase of the asset and the receipt of the grant are often disclosed separately because of the significance of the movements in cash flow.

Deducting the grant from the cost of the asset is simpler, but the deferred income method has the advantage that the non-current asset continues to be carried at cost in the financial statements.
7.4.2 Presentation of grants related to income

These grants are a credit in profit or loss, but there is a choice in the method of presentation.

Some would argue that offsetting income and expenses in the statement of profit or loss is not good practice. Others would say that the expense would not have been incurred had the grant not been available, so offsetting the two is acceptable. Although both methods are acceptable, disclosure of the grant may be necessary for a proper understanding of the financial statements, particularly the effect on any item of income or expense which is required to be separately disclosed.

7.5 Repayment of government grants

If a grant must be repaid it should be accounted for as a change in accounting estimate (see SFRS(I) 1-8).

(a) Repayment of a grant related to income: apply first against any unamortised deferred income set up in respect of the grant; any excess should be recognised immediately as an expense.

(b) Repayment of a grant related to an asset: increase the carrying amount of the asset or reduce the deferred income balance by the amount repayable. The cumulative additional depreciation that would have been recognised to date in the absence of the grant should be immediately recognised as an expense.

It is possible that the circumstances surrounding repayment may require a review of the asset value and an impairment of the new carrying amount of the asset.

7.6 Government loans

The benefit associated with a government loan at a below market rate of interest is treated as a government grant. The benefit is measured as the difference between the initial carrying amount of the loan (in accordance with SFRS(I) 9) and the proceeds received.

When matching the benefit of the loan to the costs for which it is intended to compensate, the conditions and obligations that have been or must be met should be considered.

7.7 Government assistance

Some forms of government assistance are excluded from the definition of government grants.

(a) Some forms of government assistance cannot reasonably have a value placed on them, eg free technical or marketing advice, provision of guarantees.

(b) There are transactions with government which cannot be distinguished from the entity’s normal trading transactions, eg government procurement policy resulting in a portion of the entity’s sales. Any segregation would be arbitrary.

Disclosure of such assistance may be necessary because of its significance; its nature, extent and duration should be disclosed.
7.8 Disclosure

Disclosure is required of the following.

- **Accounting policy** adopted, including method of presentation
- **Nature and extent** of government grants recognised and other forms of assistance received
- **Unfulfilled conditions and other contingencies** attached to recognised government assistance

7.9 SFRS(I) INT 1-10 Government Assistance – No Specific Relation to Operating Activities

In some countries government assistance to entities may be aimed at encouragement or long-term support of business activities either in certain regions or industry sectors. Conditions to receive such assistance may not be specifically related to the operating activities of the entity. Examples of such assistance are transfers of resources by governments to entities which:

(a) Operate in a particular industry
(b) Continue operating in recently privatised industries
(c) Start or continue to run their business in underdeveloped areas

The issue is whether such government assistance is a 'government grant' within the scope of SFRS(I) 1-20 and, therefore, should be accounted for in accordance with this Standard.

Government assistance to entities meets the definition of government grants in SFRS(I) 1-20, even if there are no conditions specifically relating to the operating activities of the entity other than the requirement to operate in certain regions or industry sectors. Such grants should therefore not be credited directly to equity.

SECTION SUMMARY

SFRS(I) 1-20 requires grants to be recognised as income over the relevant periods to match them with the related costs. Grants related to assets may be set up as deferred income or may be deducted from the cost of the asset in arriving at the carrying amount.
Chapter Roundup

**SFRS(I) 1-40 Investment Property**

- Held to earn rentals or for capital appreciation or both
- Being constructed for use as an investment property
- Includes property held as right-of-use asset
- Includes property where insignificant ancillary services provided
- Separate dual use property if could sell/lease separately

**Measurement**

- **Initial**
  - Owned: cost + transaction costs
  - Right-of-use asset: apply SFRS(I) 16

- **Subsequent**
  - FV model
  - Cost model
  - Apply SFRS(I) 13 (to property/right-of-use asset)
  - Gain/losses in Profit or loss
  - Apply SFRS(I) 5 if held for sale
  - Apply SFRS(I) 16 if right-of-use asset
  - Otherwise SFRS(I) 1-16

**Transfers**

- IP at FV to owner-occupied or inventory FV at transfer date is deemed cost
- Owner occupied or right-of-use asset to IP at FV Revalue (SFRS(I) 1-16) then transfer at FV
- Inventory to IP at FV Transfer at FV with gains or losses in profit or loss

**Disclosure**

- Details of measurement model
- Rental income and expenses
- Restrictions/obligations
- Reconciliation of b/f to c/f balance
- FV of property under cost model

**Investment Property**
Government grants

Transfers of resources in return for compliance with conditions

Recognition
- Conditions:
  - Compliance with conditions
  - Will receive grant
- Recognise as income over period to match to related costs

Presentation
- Related to income
- Separate credit OR deduct from expense
- Deferred income OR deduct from asset

Government assistance

Action designed to provide economic benefit

Disclose if significant

SFRS(I) 1-20 Accounting for Government Grants and Disclosure of Government Assistance
Quick Quiz

1. What is the correct accounting treatment for property being constructed for future use as investment property?
2. Is land held for an undetermined future use investment property?
3. How is a property which is partly owner-occupied and partly leased out to tenants classified?
4. How is investment property initially measured?
5. Where the cost model is applied, how is investment property measured in the statement of financial position?
6. Where are gains and losses recognised when the fair value model is applied?
7. Where owner-occupied property is transferred to investment property held under the fair value model, what is the accounting procedure?
8. What disclosures are required specifically in respect of investment property held under the fair value model?
9. What are the two methods permitted for the presentation of government grants related to assets?
Answers to Quick Quiz

1. Account for as Investment Property in accordance with SFRS(I) 1-40.
2. Yes
3. The property is split and accounted for in part under SFRS(I) 1-16 and in part under SFRS(I) 1-40 if the separate portions could be sold (or leased) separately. Otherwise the whole property is accounted for under SFRS(I) 1-16 if the owner-occupied portion is significant or under SFRS(I) 1-40 if the owner-occupied portion is insignificant.
4. At cost, including transaction costs (if owned) or in line with SFRS(I) 16 (if held as a right-of-use asset).
5. In line with SFRS(I) 5 if held-for-sale; in line with SFRS(I) 16 if held as a right-of-use asset; otherwise SFRS(I) 1-16 is applied.
6. In profit or loss
7. The property is revalued in accordance with SFRS(I) 1-16 prior to the transfer.
8. A reconciliation of fair value at the start and end of the accounting period must be disclosed.
9. Reduce carrying amount of the asset or treat the grant as deferred income.

Answer to Question

8.1 Investment property

(a) Yes. If an entity has not determined that it will use land either as an owner-occupied property or for short-term sale in the ordinary course of business, the land is considered to be held for capital appreciation (SFRS(I) 1-40.8(b)).

(b) Yes. A building which is vacant but is held to be leased out under one or more operating leases is investment property (SFRS(I) 1-40.8(d)).

(c) The building is an investment property in Somerset Trading's separate financial statements, however in the Somerset Trading consolidated financial statements this is owner-occupied property (SFRS(I) 1-40.15).
This chapter covers two standards that you will have met before: SFRS(I) 1-2 Inventories and SFRS(I) 1-38 Intangible Assets. It also considers the SFRS(I) 3 requirements in respect of accounting for goodwill. You must be familiar with SFRS(I) INT 1-32 Intangible Assets – Web Site Costs.

<table>
<thead>
<tr>
<th>Topic list</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 SFRS(I) 1-2 Inventories</td>
</tr>
<tr>
<td>2 SFRS(I) 1-38 Intangible Assets</td>
</tr>
<tr>
<td>3 Recognition of intangible assets</td>
</tr>
<tr>
<td>4 Measurement of intangible assets</td>
</tr>
<tr>
<td>5 Disclosure requirements</td>
</tr>
<tr>
<td>6 Goodwill</td>
</tr>
<tr>
<td>7 Related interpretations</td>
</tr>
</tbody>
</table>
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measurement and Reporting (Assets)</strong></td>
<td></td>
</tr>
<tr>
<td>Apply, explain and evaluate accounting standards for major classes of assets, insofar as they affect initial recognition, measurement (including initial measurement and subsequent re-measurement), classification and disclosure and de-recognition from an entity's statement of financial position.</td>
<td>3</td>
</tr>
<tr>
<td><strong>Specific Applications (Assets)</strong></td>
<td></td>
</tr>
<tr>
<td>Apply the relevant accounting treatment on the following classes of assets: Inventory; Goodwill and other intangible assets.</td>
<td>3</td>
</tr>
<tr>
<td><strong>Emerging Trends</strong></td>
<td></td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments.</td>
<td>1</td>
</tr>
</tbody>
</table>

**ESSENTIAL READING**

SFRS(I) 1-2 *Inventories*, SFRS(I) 1-38 *Intangible Assets*, SFRS(I) 3 *Business Combinations*, SFRS(I) INT 1-32 *Intangible Assets – Web Site Costs*, SFRS(I) INT 12 *Service Concession Arrangements*, SFRS(I) INT 1-29 *Service Concession Arrangements: Disclosures*

1 **SFRS(I) 1-2 Inventories**

**SECTION INTRODUCTION**

SFRS(I) 1-2 *Inventories* concentrates on the measurement of inventories in the financial statements.

1.1 Introduction

In most businesses the value put on inventory is an important factor in the determination of profit. Inventory valuation can be, however, a highly subjective exercise and consequently, there is a wide variety of different methods used in practice.

1.2 SFRS(I) 1-2 Inventories

SFRS(I) 1-2 lays out the required accounting treatment for inventories (sometimes called stock) under the historical cost system. Inventory is recognised as an asset of the entity until the related revenues are recognised (ie the item is sold) at which point the inventory is recognised as an expense (ie cost of sales). Part or all of the cost of inventories may also be expensed if a write-down to net realisable value is necessary. The standard also provides guidance on the cost formulae that are used to assign costs to inventories.

In other words, the fundamental accounting assumption of *accruals* requires costs to be matched with associated revenues. In order to achieve this, costs incurred for goods which remain unsold at the year-end must be carried forward in the statement of financial position and matched against future revenues.
1.3 Scope

The following items are excluded from the scope of the standard.

- Financial instruments (ie shares, bonds)
- Biological assets

Certain inventories are exempt from the standard's measurement rules, including those held by:

- Producers of agricultural and forest products
- Commodity-broker traders

1.4 Definitions

The following definitions are important.

**KEY TERMS**

**INVENTORIES** are assets:
- Held for sale in the ordinary course of business;
- In the process of production for such sale; or
- In the form of materials or supplies to be consumed in the production process or in the rendering of services.

**NET REALISABLE VALUE** is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.  (SFRS(I) 1-2)

**FAIR VALUE** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.  (SFRS(I) 13)

Inventories can include any of the following.

(a) Goods purchased and held for sale, eg goods held for sale by a retailer, or land and buildings held for resale by a property developer
(b) Finished goods produced
(c) Work in progress being produced
(d) Materials and supplies awaiting use in the production process (raw materials)

1.5 Measurement of inventories

The standard states that 'Inventories shall be measured at the lower of cost and net realisable value.'
1.6 Cost of inventories

The cost of inventories consists of:

\[
\text{Costs of purchase} + \text{Costs of conversion} + \text{Other costs to bring inventory to present condition and location}
\]

1.6.1 Costs of purchase

The standard lists the following as comprising the costs of purchase of inventories:

(a) **Purchase price plus**

(b) **Import duties and other taxes plus**

(c) Transport, handling and any other cost **directly attributable** to the acquisition of finished goods, services and materials **less**

(d) **Trade discounts**, rebates and other similar amounts

1.6.2 Costs of conversion

Costs of conversion of inventories consist of two main parts.

(a) Costs **directly related** to the units of production, eg direct materials, direct labour

(b) Fixed and variable **production overheads** that are incurred in converting materials into finished goods, allocated on a systematic basis

You may have come across the terms 'fixed production overheads' or 'variable production overheads' elsewhere in your studies. The standard defines them as follows.

**KEY TERMS**

**Fixed production overheads** are those indirect costs of production that remain relatively constant regardless of the volume of production, eg the cost of factory management and administration.

**Variable production overheads** are those indirect costs of production that vary directly, or nearly directly, with the volume of production, eg indirect materials and labour. (SFRS(I) 1-2)

The standard emphasises that fixed production overheads must be allocated to items of inventory on the basis of the **normal capacity of the production facilities**. This is an important point.

(a) **Normal capacity** is the expected achievable production based on the average over several periods/seasons, under normal circumstances.

(b) The above figure should take into account the capacity lost through **planned maintenance**.

(c) If it approximates to the normal capacity then the **actual level of production** can be used.

(d) **Low production** or **idle plant** will not result in a higher fixed overhead allocation to each unit.

(e) **Unallocated fixed overheads** are recognised as an expense in the period in which they were incurred.

(f) When production is **abnormally high**, the fixed production overhead allocated to each unit will be reduced, so avoiding inventories being stated at more than cost.

(g) The allocation of variable production overheads to each unit is based on the **actual use** of production facilities.
1.6.3 Other costs

Any other costs should only be recognised if they are incurred in bringing the inventories to their present location and condition.

The standard lists types of cost which would not be included in cost of inventories. Instead, they should be recognised as an expense in the period they are incurred. These costs include:

(a) Abnormal amounts of wasted materials, labour or other production costs
(b) Storage costs (except costs which are necessary in the production process before a further production stage)
(c) Administrative overheads not incurred to bring inventories to their present location and condition
(d) Selling costs

SFRS(I) 1-2 is also clear that borrowing costs incurred as a result of acquiring inventories on deferred settlement terms are recognised as an expense over the period of financing.

1.6.4 Techniques for the measurement of cost

Two techniques are mentioned by the standard, both of which produce results which approximate to actual cost, and so either may be used for convenience.

(a) Standard costs are set up to take account of normal production values: amount of raw materials used, labour time etc. They are reviewed and revised on a regular basis.
(b) Retail method: this is often used in the retail industry where there is a large turnover of inventory items, which have similar profit margins. The only practical method of inventory valuation may be to take the sales value of the inventory, reduced by the appropriate percentage gross margin, thus reducing the value to an approximation of cost. The percentage will take into account reduced price lines. An average percentage for each retail department is often used.

1.7 Cost formulae

Cost of inventories should be assigned by specific identification of their individual costs for:

- Items that are not ordinarily interchangeable
- Goods or services produced and segregated for specific projects

Specific costs should be attributed to identified items of inventory when they are segregated for a specific project, but not where inventories consist of a large number of interchangeable (i.e. identical or very similar) items. In the latter case the rule is as specified below.

1.7.1 Interchangeable items

The cost of inventories should be assigned by using either the first-in-first-out (FIFO) or weighted average cost formula. The use of last in first out (LIFO) is not permitted by SFRS(I) 1-2.

You should be familiar with these methods from your earlier studies. Under the weighted average cost method, a recalculation can be made after each purchase, or alternatively only at the period end.

1.8 Net realisable value (NRV)

Inventories are required to be stated at the lower of cost and net realisable value (NRV). NRV could fall below cost when items are damaged or become obsolete, or where the costs to completion have increased in order to make the sale.
In fact we can identify the principal situations in which NRV is likely to be less than cost, ie where there has been:

- An increase in costs (eg completion costs, selling costs) or a fall in selling price
- A physical deterioration in the condition of inventory
- Obsolescence of products
- A decision as part of the company’s marketing strategy to manufacture and sell products at a loss
- Errors in production or purchasing

A write down of inventories would normally take place on an item by item basis, but similar or related items may be grouped together. This grouping together is acceptable for, say, items in the same product line, but it is not acceptable to write down inventories on the basis of a classification of inventory, for example finished goods, or all the inventories in a particular operating segment.

The assessment of NRV should take place at the same time as estimates are made of selling price, using the most reliable information available. Fluctuations of price or cost should be taken into account if they relate directly to events after the reporting period, which confirm conditions existing at the end of the period.

The reasons why inventory is held must also be taken into account. Some inventory, for example, may be held to satisfy a firm contract and its NRV will therefore be the contract price. Any additional inventory of the same type held at the period end will, in contrast, be assessed according to general sales prices when NRV is estimated.

Net realisable value must be reassessed at the end of each period and compared again with cost. If the NRV has risen for inventories held over the end of more than one period, then the previous write down must be reversed to the extent that the inventory is then valued at the lower of cost and the new NRV. This may be possible when selling prices have fallen in the past and then risen again.

On occasion a write down to NRV may be of such size, incidence or nature that it must be disclosed separately.

1.9 Recognition as an expense

The following treatment is required when inventories are sold.

(a) The carrying amount is recognised as an expense in the period in which the related revenue is recognised

(b) The amount of any write-down of inventories to NRV and all losses of inventories are recognised as an expense in the period the write-down or loss occurs

(c) The amount of any reversal of any write-down of inventories, arising from an increase in NRV, is recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs

Question 9.1

A company has inventory on hand at the end of the reporting period as follows:

<table>
<thead>
<tr>
<th>Items</th>
<th>Units</th>
<th>Raw material cost/unit</th>
<th>Attributable production overheads/unit</th>
<th>Attributable selling costs/unit</th>
<th>Expected selling price/unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item A</td>
<td>300</td>
<td>$160</td>
<td>$15</td>
<td>$12</td>
<td>$185</td>
</tr>
<tr>
<td>Item B</td>
<td>250</td>
<td>$50</td>
<td>$10</td>
<td>$10</td>
<td>$75</td>
</tr>
</tbody>
</table>

At what amount will inventories be stated in the statement of financial position in accordance with SFRS(I) 1-2?
1.10 Consistency – different cost formulae for inventories
SFRS(I) 1-2 allows two cost formulae (FIFO or weighted average cost) for inventories that are ordinarily interchangeable or are not produced and segregated for specific projects. The issue is whether an entity may use different cost formulae for different types of inventories.

SFRS(I) 1-2 provides that an entity should use **the same cost formula for all inventories having similar nature and use to the entity**. For inventories with different nature or use (for example, certain commodities used in one business segment and the same type of commodities used in another business segment), different cost formulae may be justified. A difference in geographical location of inventories (and in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulae.

1.11 Disclosure
SFRS(I) 1-2 requires disclosure of the following in respect of inventories:

(a) The accounting policies used to measure inventories including the cost formula used;
(b) The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;
(c) The carrying amount of inventories carried at fair value less costs to sell;
(d) The amount of inventories recognised as an expense in the period;
(e) The amount of any write down of inventories recognised as an expense in the period;
(f) The amount of any reversal of write down that is recognised as a reduction in the amount of inventories recognised as an expense in the period;
(g) The circumstances or events that led to the reversal of a write down of inventories; and
(h) The carrying amount of inventories pledged as securities for liabilities.

SECTION SUMMARY
SFRS(I) 1-2 requires that inventories are measured at the lower of cost and net realisable value. Cost of interchangeable items is assigned using either the first-in-first-out or weighted average method.

2 SFRS(I) 1-38 Intangible Assets

SECTION INTRODUCTION
The definition of an intangible asset is key; an intangible asset must meet the definition before it may be recognised in the financial statements.

The objectives of SFRS(I) 1-38 Intangible Assets are:
- To establish the criteria for when an intangible asset may or should be recognised
- To specify how intangible assets should be measured
- To specify the disclosure requirements for intangible assets
It applies to all intangible assets with certain exceptions: intangible assets held by an entity for sale in the ordinary course of business (SFRS(I) 1-2), deferred tax assets (SFRS(I) 1-12), leases that fall within the scope of SFRS(I) 16, financial assets as defined in SFRS(I) 1-32, insurance contracts (SFRS(I) 4 or SFRS(I) 17), assets arising from employee benefits (SFRS(I) 1-19), non-current assets held for sale (SFRS(I) 5) and mineral rights and exploration and extraction costs for minerals (SFRS(I) 6) (although intangible assets used to develop or maintain these rights are covered by the standard). It does not apply to goodwill acquired in a business combination, which is dealt with under SFRS(I) 3 Business Combinations.

2.1 Definition of an intangible asset

The definition of an intangible asset is a key aspect of SFRS(I) 1-38, because an intangible asset may only be recognised in the accounts of an entity when it meets the definition.

**KEY TERM**

An intangible asset is an identifiable non-monetary asset without physical substance. The asset must be both:

- Controlled by the entity as a result of events in the past
- Something from which the entity expects future economic benefits to flow

Examples of items that might be considered as intangible assets include computer software, patents, copyrights, motion picture films, customer lists, franchises and fishing rights. An item should not be recognised as an intangible asset, however, unless it fully meets the definition in the standard. In other words it must be:

<table>
<thead>
<tr>
<th>Identifiable</th>
<th>AND</th>
<th>Controlled by entity as a result of past events</th>
<th>AND</th>
<th>Expected to result in economic benefits</th>
</tr>
</thead>
</table>

Expenditure on certain internally generated intangible assets (e.g., brands, mastheads, publishing titles and customer lists) cannot be distinguished from the cost of developing the business as a whole. In accordance with SFRS(I) 1-38 these items are not recognised as intangibles. Expenditure which does not meet the definition of an intangible asset should be recognised as an expense.

2.1.1 Identifiable

SFRS(I) 1-38 states that an asset is identifiable if it:

(a) Is separable i.e., capable of being separated and sold individually or together with a related contract, asset or liability; or

(b) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable.

**Purchased intangible assets** such as a purchased brand are normally identifiable.

**Internally generated intangible assets** such as a customer list are normally identifiable, however they may not meet the other criteria within the definition of an intangible asset (see Section 2.1 above).

**Goodwill** is not identifiable regardless of whether it is purchased or internally generated. Therefore this is not an intangible asset within the scope of SFRS(I) 1-38. SFRS(I) 3 applies to purchased goodwill.

2.1.2 Controlled by the entity

Another element of the definition of an intangible asset is that it must be under the control of the entity as a result of a past event. An entity controls an asset if it has the power to obtain the future economic benefits generated by the asset, and prevent the access of others to those benefits.
A legally enforceable right is evidence of such control, but is not always a necessary condition.

(a) Control over technical knowledge or know-how only exists if it is protected by a legal right.

(b) The skill of employees, arising out of the benefits of training costs, are most unlikely to meet the definition of an intangible asset, because an entity does not control the future actions of its staff.

(c) Similarly, market share and customer loyalty cannot normally be intangible assets, since an entity cannot control the actions of its customers.

2.1.3 Expected future economic benefits

An item only meets the definition of an intangible asset if economic benefits are expected to flow in the future from ownership of the asset. Economic benefits may come from the sale of products or services, or from a reduction in expenditures (cost savings).

Where an intangible asset is purchased, it is almost always because that asset will result in future economic benefits. Whether an asset will result in probable economic benefits is harder to assess when that asset is internally generated. SFRS(I) 1-38 states that an entity classifies the generation of such an asset into a research phase and a development phase and provides additional criteria for assessing whether these will result in probable economic benefits. Research and development as specifically defined by SFRS(I) 1-38 are discussed later in this chapter.

SECTION SUMMARY

Intangible assets are defined by SFRS(I) 1-38 as non-monetary assets without physical substance. They must:

• Be identifiable
• Be controlled as a result of a past event
• Result in expected future economic benefits
• Meet specific recognition criteria (see section 3)

Before being recognised in the financial statements as an intangible asset.

3 Recognition of intangible assets

SECTION INTRODUCTION

An intangible asset is recognised in the financial statements when it meets the definition of an intangible asset and the SFRS(I) 1-38 recognition criteria.
An intangible asset should be recognised if, and only if, both of the following are true:

**Recognition criteria**

- Probable future economic benefits attributable to the asset will flow to the entity
- Cost can be measured reliably

Management has to exercise its judgment in assessing the degree of certainty attached to the flow of economic benefits to the entity. External evidence is best.

The recognition criteria can be applied to acquired intangible assets as follows:

(a) If an intangible asset is **acquired separately**, its cost can usually be measured reliably as its purchase price (including incidental costs of purchase such as legal fees, and any costs incurred in getting the asset ready for use), and as already mentioned, future economic benefits of the asset are expected to flow to the entity. Therefore separately acquired intangible assets normally meet the recognition criteria.

(b) When an intangible asset is acquired as **part of a business combination** (i.e., an acquisition or takeover), the cost of the intangible asset is its fair value at the date of the acquisition. Any intangible asset for which a fair value can be established should be recognised in accordance with SFRS(I) 3.

As previously mentioned, some internally generated intangible assets are classified as research or development costs and SFRS(I) 1-38 provides additional detailed guidance on the recognition of these costs.

**SFRS(I) 1-38 states that internally-generated brands, mastheads, publishing titles, customer lists and items similar in substance are not recognised as intangible assets.**

### 3.1 Recognition of expenses

All expenditure related to an intangible which does not meet the criteria for recognition either as an identifiable intangible asset or as goodwill arising on an acquisition should be **expensed as incurred**. The Standard gives examples of such expenditure.

- Start-up costs
- Training costs
- Advertising costs
- Business relocation costs

**Prepaid costs for services**, for example advertising or marketing costs for campaigns that have been prepared but not launched, can still be recognised as a **prepayment**.

Expenditure on an intangible item that was previously recognised as an expense may not subsequently be recognised as part of the cost of the asset.

### 3.2 Research and development

SFRS(I) 1-38 requires that expenditure on some internally generated intangible assets is classified as either research or development in order to assess whether it is recognised in the financial statements.
3.2.1 Research

Research activities by definition do not meet the criteria for recognition under SFRS(I) 1-38. This is because, at the research stage of a project, it cannot be certain that future economic benefits will probably flow to the entity from the project. There is too much uncertainty about the likely success or otherwise of the project. **Research costs should therefore be written off as an expense as they are incurred.**

**Examples of research costs**

(a) Activities aimed at obtaining new knowledge
(b) The search for, evaluation and final selection of, applications of research findings or other knowledge
(c) The search for alternatives for materials, devices, products, processes, systems or services
(d) The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, systems or services

3.2.2 Development

Development costs **may qualify** for recognition as intangible assets provided that the following **strict criteria** are met.

(a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.
(b) Its intention to complete the intangible asset and use or sell it.
(c) Its ability to use or sell the intangible asset.
(d) How the intangible asset will generate probable future economic benefits. Among other things, the entity should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
(e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
(f) Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

In contrast with research costs, development costs are incurred at a later stage in a project, and the probability of success should be more apparent. Examples of development costs include the following.

(a) The design, construction and testing of pre-production or pre-use prototypes and models
(b) The design of tools, jigs, moulds and dies involving new technology
(c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production
(d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services
Example

**Computer software and hardware**

The treatments of different types of intangible assets can be illustrated by reference to computer software and hardware. The treatment depends on the nature of the asset and its origin.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Origin</th>
<th>Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer software</td>
<td>Purchased</td>
<td>Capitalise and amortise over the useful life, and write down for impairment if necessary</td>
</tr>
<tr>
<td>Operating system for hardware</td>
<td>Purchased</td>
<td>Include in hardware cost and amortise over the useful life, and write down for impairment if necessary</td>
</tr>
<tr>
<td>Computer software (for use or sale)</td>
<td>Internally developed</td>
<td>Charge to expense until ‘Development criteria’ (Section 3.2.2 above) are met. Amortise over useful life, based on pattern of benefits. Straight line is default.</td>
</tr>
</tbody>
</table>

**SECTION SUMMARY**

Intangible assets are recognised when they meet the definition of an intangible asset and:

- It is probable that future economic benefits will flow to the entity
- The cost can be measured reliably

This is normally the case where an intangible asset is purchased separately.

Internally-generated brands, mastheads, publishing titles, customer lists and items similar in substance are not recognised as intangible assets.

4 Measurement of intangible assets

**SECTION INTRODUCTION**

SFRS(I) 1-38 provides guidance on initial and subsequent measurement of intangible assets.

**4.1 Initial measurement**

An intangible asset is initially measured at cost:

(a) The cost of a **separately acquired intangible asset**: is its purchase price including import duties and non-refundable taxes less discounts; and

(b) Any directly attributable cost of preparing the asset for its intended use.
(c) Directly attributable costs include professional fees, testing costs and the cost of employee benefits where those employees are involved in bringing the asset to working condition. They do not include advertising costs, costs of staff training or general administration costs.

(d) The cost of an intangible asset acquired as part of a business combination is its fair value at the date of acquisition.

(e) The cost of an intangible asset acquired by way of an exchange of assets is the asset’s fair value, unless the exchange lacks commercial substance or the fair values of the asset acquired and that given up cannot be measured. In this case deemed cost of the acquired asset is the carrying amount of the asset given up.

(f) The cost of an internally generated asset (development costs) is comprised of those costs incurred after the date when the recognition criteria were first met that can be directly attributed or allocated on a reasonable and consistent basis to creating, producing or preparing the asset for its intended use. Subsequent expenditure incurred on an in-process development project is added to the carrying amount of that project if it satisfies the recognition criteria given in section 3.2.2 above.

### Question 9.2

Pioneer Useful Technologies Ltd is developing a new production process. During 20X3, expenditure incurred was $100,000, of which $90,000 was incurred before 1 December 20X3 and $10,000 between 1 December 20X3 and 31 December 20X3. Pioneer Useful Technologies Ltd can demonstrate that, at 1 December 20X3, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process is estimated to be $50,000.

How should the expenditure be treated?

### 4.2 Subsequent measurement

The standard allows two methods of valuation for intangible assets after they have been first recognised.

(a) Under the cost model, an intangible asset is carried at its cost, less any accumulated amortisation and less any accumulated impairment losses.

(b) The revaluation model allows an intangible asset to be carried at a revalued amount, which is its fair value at the date of revaluation, less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

Where the revaluation model is adopted, the following rules apply:

(a) The fair value must be able to be measured reliably with reference to an active market in that type of asset.

(b) The entire class of intangible assets of that type must be revalued at the same time (to prevent selective revaluations).

(c) If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset should be carried at its cost less any accumulated amortisation and impairment losses.

(d) Revaluations should be made with such regularity that the carrying amount does not differ materially from that which would be determined using fair value at the year-end.

The guidelines state that there will not usually be an active market in an intangible asset; therefore the revaluation model will usually not be available. For example, although copyrights, publishing rights and film rights can be sold, each has a unique sale value. In such cases, revaluation to fair value would be inappropriate. A fair value might be obtainable however for assets such as fishing rights or quotas or taxi cab licences.

Where an intangible asset is revalued upwards to a fair value, the amount of the revaluation should be credited directly to equity under the heading of a revaluation surplus.
However, if the increase in carrying amount is a reversal of a revaluation decrease that was previously charged against income, the increase shall be recognised as income to the extent that it reverses any previous devaluation.

Where the carrying amount of an intangible asset is revalued downwards, the amount of the downward revaluation should be charged as an expense against income, unless the asset has previously been revalued upwards. A revaluation decrease should be first charged against any previous revaluation surplus in respect of that asset.

**Question 9.3 Downward valuation**

An intangible asset is measured by a company at fair value. The asset was revalued up by $400 in 20X3, and there is a revaluation surplus of $400 in the statement of financial position. At the end of 20X4, the asset is valued again, and a downward valuation of $500 is required.

**Required**

State the accounting treatment for the downward revaluation.

When the revaluation model is used, and an intangible asset is revalued upwards, the cumulative revaluation surplus may be transferred to retained earnings when the surplus is eventually realised. The surplus would be realised when the asset is retired or disposed of. However, the surplus may also be realised over time as the asset is used by the entity. The amount of the surplus realised each year is the difference between the amortisation charge for the asset based on the revalued amount of the asset, and the amortisation that would be charged on the basis of the asset's historical cost. The realised surplus in such case should be transferred from revaluation surplus directly to retained earnings, and should not be taken through profit or loss for the year.

**4.3 Amortisation**

Amortisation is the term used for the systematic allocation of the depreciable amount of an intangible asset over its useful life, while depreciation is used for depreciable tangible assets.

An entity should assess the useful life of an intangible asset, which may be finite or indefinite. An intangible asset has an indefinite useful life when there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

An intangible asset with a finite useful life should be amortised over its expected useful life.

(a) Amortisation should start when the asset is available for use.

(b) Amortisation should cease at the earlier of the date that the asset is classified as held for sale in accordance with SFRS(I) 5 Non-current Assets Held for Sale and Discontinued Operations and the date that the asset is derecognised.

(c) The amortisation charge for each period should normally be recognised in profit or loss.

**4.3.1 Useful life**

Many factors are considered in determining the useful life of an intangible asset, including: expected usage; typical product life cycles; technical, technological, commercial or other types of obsolescence; the stability of the industry; expected actions by competitors; the level of maintenance expenditure required; and legal or similar limits on the use of the asset, such as the expiry dates of related leases. Computer software and many other intangible assets normally have short lives because they are susceptible to technological obsolescence. However, uncertainty does not justify choosing a life that is unrealistically short.

The useful life of an intangible asset that arises from contractual or other legal rights should not exceed the period of the rights, but may be shorter depending on the period over which the entity expects to use the asset.
4.3.2 Residual value
The residual value of an intangible asset with a finite useful life is assumed to be zero unless a third party is committed to buying the intangible asset at the end of its useful life or unless there is an active market for that type of asset (so that its expected residual value can be measured) and it is probable that there will be a market for the asset at the end of its useful life.

4.3.3 Amortisation method
The amortisation method used should reflect the pattern in which the asset's future economic benefits are consumed. If such a pattern cannot be predicted reliably, the straight-line method should be used.

SFRS(I) 1-38 includes a rebuttable presumption that a revenue-based amortisation method is inappropriate. A revenue-based amortisation method allocates an intangible asset's depreciable amount over its life based on revenues generated in an accounting period as a proportion of total revenues generated over the asset's life. Such a method is normally inappropriate because there are multiple factors that influence revenue and these are not all related to the way in which an asset is consumed.

SFRS(I) 1-38 allows the presumption to be rebutted in limited circumstances if:
(a) The intangible asset is expressed as a measure of revenue (i.e., the predominant limiting factor inherent in an intangible asset is the achievement of a contractually specified revenue threshold).
(b) It can be demonstrated that revenue generation and the consumption of economic benefits of the asset are highly correlated.

EXAMPLE
Pan-Asia Mining Corporation has acquired a concession to explore and extract gold from a gold mine. The contract expires when the total cumulative revenue from the sale of gold reaches $50 million.

In this case the SFRS(I) 1-38 presumption that a revenue-based method of amortisation is inappropriate may be rebutted as the intangible asset (the concession) is expressed in terms of revenue. It remains that another basis of amortisation may be more appropriate if it more closely reflects the expected pattern of consumption of economic benefits.

4.3.4 Review of estimates
The amortisation period and the amortisation method used for an intangible asset with a finite useful life should be reviewed at least at each financial year-end.

4.4 Amortisation and revaluation
If the revaluation model is applied to an intangible asset, at the date of revaluation the carrying amount of the asset is adjusted to the revalued amount. SFRS(I) 1-38 clarifies that this adjustment is achieved in one of two ways:
(a) The gross carrying amount of the asset is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated amortisation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses; or
(b) The accumulated amortisation is eliminated against the gross carrying amount of the asset.

This Textbook is prepared on the assumption that method (b) is used.
4.5 Intangible assets with indefinite useful lives

An intangible asset with an indefinite useful life should not be amortised. (SFRS(I) 1-36 requires that such an asset is tested for impairment at least annually.)

The useful life of an intangible asset that is not being amortised should be reviewed each year to determine whether it is still appropriate to assess its useful life as indefinite. Reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired and therefore it should be tested for impairment.

**Question 9.4**

It may be difficult to establish the useful life of an intangible asset, and judgment will be needed. Consider how to determine the useful life of a purchased brand name.

4.6 Disposals/retirements of intangible assets

An intangible asset should be eliminated from the statement of financial position when it is disposed of or when there is no further expected economic benefit from its future use. On disposal the gain or loss arising from the difference between the net disposal proceeds and the carrying amount of the asset should be taken to the profit or loss for the year as a gain or loss on disposal. Gains must not be recognised as revenue.

**SECTION SUMMARY**

Intangible assets are initially measured at cost. Subsequently either the cost model or the revaluation model is applied; the revaluation model is available only where fair value can be ascertained by reference to an active market. Intangible assets with a finite useful life are amortised; those with an indefinite useful life are not amortised but are subject to an annual impairment review.

5 Disclosure requirements

**SECTION INTRODUCTION**

SFRS(I) 1-38 has extensive disclosure requirements for intangible assets and these are covered by paragraphs 118–128 of the standard.

The financial statements should disclose the accounting policies that have been adopted for intangible assets.

A summary of the key disclosures is given below but it is recommended that you refer to the standard itself. For each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets, disclosure is required of the following:

(a) The method of amortisation used

(b) The useful life of the assets or the amortisation rate used

(c) The gross carrying amount, the accumulated amortisation and the accumulated impairment losses as at the beginning and the end of the period
(d) A reconciliation of the carrying amount as at the beginning and at the end of the period (additions, retirements/disposals, revaluations, impairment losses, impairment losses reversed, amortisation charge for the period, net exchange differences, other movements)

(e) The line item(s) of the statement of the comprehensive income in which any amortisation of any intangible assets is included

The financial statements should also disclose the following:

(a) In the case of intangible assets that are assessed as having an indefinite useful life, the carrying amounts and the reasons supporting that assessment

(b) For intangible assets acquired by way of a government grant and initially recognised at fair value, the fair value initially recognised, the carrying amount, and whether they are measured after recognition under the cost model or the revaluation model

(c) The carrying amount, nature and remaining amortisation period of any intangible asset that is material to the financial statements of the entity as a whole

(d) The existence (if any) and amounts of intangible assets whose title is restricted and of intangible assets that have been pledged as security for liabilities

(e) The amount of any commitments for the future acquisition of intangible assets

Where intangible assets are accounted for at revalued amounts, disclosure is required of the following:

(a) The effective date of the revaluation (by class of intangible assets)

(b) The carrying amount of revalued intangible assets (by class of intangible assets)

(c) The carrying amount that would have been recognised (by class of intangible assets) if the cost model had been used

(d) The amount of any revaluation surplus on intangible assets, as at the beginning and end of the period, and movements in the surplus during the year (and any restrictions on the distribution of the balance to shareholders)

The financial statements should also disclose the amount of research and development expenditure that have been charged as expenses of the period.

**SECTION SUMMARY**

SFRS(I) 1-38 has extensive disclosure requirements including a reconciliation of the carrying amount of intangible assets at the start and end of the reporting period.
Question 9.5  Research and development

(a) As an aid to your revision, list the examples given in SFRS(I) 1-38 of activities that might be included in either research or development.

(b) Serangoon Steel Ltd develops and manufactures exotic cutlery and has the following projects in hand.

<table>
<thead>
<tr>
<th>Project</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred development expenditure b/f 1.1.X2</td>
<td>280</td>
<td>450</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Development expenditure incurred during the year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>35</td>
<td>–</td>
<td>60</td>
<td>20</td>
</tr>
<tr>
<td>Overhead costs</td>
<td>2</td>
<td>–</td>
<td>–</td>
<td>3</td>
</tr>
<tr>
<td>Materials and services</td>
<td>3</td>
<td>–</td>
<td>11</td>
<td>4</td>
</tr>
<tr>
<td>Patents and licences</td>
<td>1</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Market research</td>
<td>–</td>
<td>–</td>
<td>2</td>
<td>–</td>
</tr>
</tbody>
</table>

Deferred development expenditure relates to expenditure which has been incurred and which has met the criteria for recognition as an intangible asset.

**Project 1:** originally expected to be highly profitable but this is now in doubt, since the scientist in charge of the project is now behind schedule, with the result that competitors are gaining ground.

**Project 2:** commercial production started during the year. Sales were 20,000 units in 20X2 and future sales are expected to be: 20X3 30,000 units; 20X4 60,000 units; 20X5 40,000 units; 20X6 30,000 units. There are no sales expected after 20X6.

**Project 3:** these costs relate to a new project, which meets the criteria for deferral of expenditure and which is expected to last for three years.

**Project 4:** is another new project, involving the development of a ‘loss leader’, expected to raise the level of future sales.

The company’s policy is to defer development costs, where required by SFRS(I) 1-38. Expenditure carried forward is written off evenly over the expected sales life of projects, starting in the first year of sale.

**Required**

Show how the above projects should be treated in the financial statements of Serangoon Steel Ltd for the year ended 31 December 20X2 in accordance with best accounting practice. Justify your treatment of each project.

6 Goodwill

**SECTION INTRODUCTION**

Purchased goodwill is a specific type of intangible asset which does not fall within the scope of SFRS(I) 1-38 **Intangible Assets.**
Goodwill is created by good relationships between a business and its customers.

(a) By building up a reputation (by word of mouth perhaps) for high quality products or high standards of service

(b) By responding promptly and helpfully to queries and complaints from customers

(c) Through the personality of the staff and their attitudes to customers

The value of goodwill to a business might be extremely significant. However, internally generated goodwill is not usually valued in the accounts of a business at all, and we should not normally expect to find an amount for goodwill in its statement of financial position.

On reflection, we might agree with this omission of goodwill from the accounts of a business.

(a) The goodwill is inherent in the business but it has not been paid for, and it does not have an 'objective' value. We can guess at what such goodwill is worth, but such guesswork would be a matter of individual opinion, and not based on hard facts.

(b) Goodwill changes from day to day. One act of bad customer relations might damage goodwill and one act of good relations might improve it. Staff with a favourable personality might retire or leave to find another job, to be replaced by staff who need time to find their feet in the job. Since goodwill is continually changing in value, it cannot realistically be recorded in the accounts of the business.

6.1 Purchased goodwill

There is one exception to the general rule that goodwill has no objective valuation. This is when a business is sold. Individuals wishing to set up in business have a choice of how to do it – they can either buy their own non-current assets and inventory and set up their business from scratch, or they can buy an existing business from a proprietor willing to sell it. When a buyer purchases an existing business, the buyer will have to purchase not only its long-term assets and inventory (and perhaps take over its accounts payable and receivable too) but also the goodwill of the business.

Purchased goodwill is shown in the purchaser's statement of financial position because it has been paid for. It has no tangible substance, and so it is an intangible non-current asset.

6.2 How is the value of purchased goodwill decided?

When a business is sold, there is likely to be some purchased goodwill in the selling price. But how is the amount of this purchased goodwill decided?

This is not really a problem for accountants, who must simply record the goodwill in the accounts of the new business. The value of the goodwill is a matter for the purchaser and seller to agree upon in fixing the purchase/sale price. However, two methods of valuation are worth mentioning here.

(a) The seller and buyer agree on a price without specifically quantifying the goodwill. The purchased goodwill will then be the difference between the price agreed and the value of the identifiable assets in the books of the new business.

(b) However, the calculation of goodwill often precedes the fixing of the purchase price and becomes a central element of negotiation. There are many ways of arriving at a value for goodwill and most of them are related to the profit record of the business in question.

No matter how goodwill is calculated within the total agreed purchase price, the goodwill recognised by the purchaser in the accounts will be the difference between the purchase consideration and his own valuation of the identifiable net assets acquired. If the fair value of the identifiable net assets of A is $40,000 and B agrees to pay $61,000 for the business then the goodwill in B’s books will be $61,000 – $40,000 = $21,000.
6.3 SFRS(I) 3 Business Combinations

SFRS(I) 3 covers the accounting treatment of goodwill acquired in a business combination.

It is possible to define goodwill in different ways. The SFRS(I) 3 definition of goodwill is different from the more traditional definition and emphasises benefits, rather than the method of calculation.

KEY TERM

**GOODWILL** An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised. 

(SFRS(I) 3)

Goodwill recognised in a business combination is an asset and is initially measured at cost. Cost is the excess of the cost of the combination plus the amount of any non-controlling interest over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities. We shall see the detailed calculation of goodwill later in the Textbook; the following is a proforma for the calculation in a simple case:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>X</td>
</tr>
<tr>
<td>Non-controlling interest in acquiree</td>
<td>X</td>
</tr>
<tr>
<td>Fair value of net identifiable assets acquired</td>
<td>(X)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>X</td>
</tr>
</tbody>
</table>

After initial recognition goodwill acquired in a business combination is measured at cost less any accumulated impairment losses. It is not amortised. Instead, it is tested for impairment at least annually, in accordance with SFRS(I) 1-36 Impairment of Assets.

6.3.1 Bargain purchase

A bargain purchase arises when the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed exceeds the consideration transferred.

A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. However, the recognition or measurement exceptions for particular items may also result in recognising a gain (or change the amount of a recognised gain) on a bargain purchase.

Before recognising a gain on a bargain purchase, the acquirer must reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and must recognise any additional assets or liabilities that are identified in that review. The acquirer must then review the procedures used to measure the amounts this SFRS(I) requires to be recognised at the acquisition date for all of the following:

(a) The identifiable assets acquired and liabilities assumed
(b) The non-controlling interest in the acquiree, if any
(c) For a business combination achieved in stages, the acquirer's previously held interest in the acquiree
(d) The consideration transferred

The purpose of this review is to ensure that the measurements appropriately reflect all the available information as at the acquisition date.
Question 9.6

What are the main characteristics of goodwill which distinguish it from other intangible non-current assets? To what extent do you consider that these characteristics should affect the accounting treatment of goodwill? State your reasons.

SECTION SUMMARY

Purchased goodwill as part of a business combination is retained in the statement of financial position as an intangible asset under the requirements of SFRS(I) 3. It must then be reviewed for impairment annually.

7 Related interpretations

SECTION INTRODUCTION

A company may incur expenditure in order to develop its own website. SFRS(I) INT 1-32 Intangible Assets – Web Site Costs addresses the accounting issues this raises. SFRS(I) INT 12 deals with service concession arrangements.

7.1 SFRS(I) INT 1-32 Intangible Assets – Web Site Costs

SFRS(I) INT 1-32 addresses two key issues:

(a) Whether the website is an internally generated intangible asset that should be accounted for in accordance with SFRS(I) 1-38
(b) How this expenditure should be treated

The SFRS(I) INT concludes that expenditure incurred in the development of an entity’s own website is an internally generated intangible asset that is subject to the requirements of SFRS(I) 1-38. Expenditure shall be recognised as an intangible asset if it complies with both of the following:

- The general recognition and initial measurement criteria of SFRS(I) 1-38 paragraph 21
- Can satisfy the requirements of SFRS(I) 1-38 paragraph 57

After initial recognition the intangible asset must be measured by applying the requirements of SFRS(I) 1-38 (paragraphs 72–87).

7.2 SFRS(I) INT 12 Service Concession Arrangements

A service concession arrangement is an arrangement whereby a government or other body (the grantor) grants contracts for the supply of public services such as roads, prisons or hospitals to private operators. SFRS(I) INT 12 identifies two types of service concession arrangement:

- Where the operator has a contractual right to receive cash or another financial asset from the grantor
- Where the operator acquires the right to charge for access to the public sector asset that it constructs or upgrades
Both types of arrangement may exist within a single contract.
In the first type of arrangement, the operator should recognise a financial asset at fair value to the extent that it has an unconditional right to receive cash or another financial asset from (or at the discretion of) the grantor.
In the second type of arrangement, the operator should recognise an intangible asset to the extent that it receives a right to charge users of the public service, This right is not an unconditional right to receive cash because cash received is dependent upon service usage.
The operator of a service concession arrangement should recognise and measure revenue in accordance with the relevant accounting standard for the services it performs.

7.2.1 SFRS(I) INT 1-29 Service Concession Arrangements: Disclosures
SFRS(I) INT 1-29 prescribes the information that should be disclosed in the financial statements of a concession operator and grantor. Disclosures include:

- A description of the arrangement
- Significant terms of the arrangement that may affect the amount, timing and certainty of cash flows
- The nature and extent of rights and obligations within the contract
- Changes in the arrangement occurring in the period
- How the service arrangement is classified

SECTION SUMMARY
SFRS(I) INT 1-32 requires that the provisions of SFRS(I) 1-38 are applied to the costs of developing a website.
Chapter Roundup

SFRS(I) 1-38 Intangible Assets

- Identifiable
- Controlled
- Expected future benefits

Separated acquired

Acquired in business combination

Internally generated

Recognise if:
1. Probable future economic benefits will flow
2. Cost/FV can be measured reliably

Recognise if:
- Technically feasible
- Intend to complete
- Commercially viable
- Probable economic benefits
- Resources available to complete
- Expenditure reliably measured

Measure at cost + directly attributable costs.

Measure at fair value at date of acquisition.

Measure at directly attributable costs since date when recognition criteria met.

Subsequent measurement

Measurement model

- Cost model
- Revaluation model (if active market)

Amortisation

- Amortise over useful life
- Residual value assumed to be nil
- Where useful life is indefinite an annual impairment test replaces amortisation

Goodwill

- Internally generated goodwill is not recognised (SFRS(I) 1-38)
- Purchased positive goodwill recognised in the statement of financial position at cost less impairment losses (SFRS(I) 3)
SFRS(I) 1-2 *Inventories*

**Lower of**

- **Cost**
  - Purchase cost
  - Costs of conversion
  - Other costs to bring to present location/condition

- **Net realisable value**
  - Estimated selling price, less
  - Estimates costs to completion, less
  - Estimated costs to sell

**Specific items**
- Actual cost

**Interchangeable items**
- FIFO or weighted average cost assumption
  - Apply consistently to similar items
Quick Quiz

1. Give examples of costs which may not be included in the cost of an item of inventory.
2. Internally generated goodwill can be recognised. True or false?
3. How should research and development costs be treated under SFRS(I) 1-38?
4. When can a revaluation surplus on intangible assets be transferred to retained earnings?
5. Over what period should an intangible asset normally be amortised?
6. How should the gain or loss on the disposal of an intangible asset be calculated?
7. Why is internally generated goodwill not recorded as an asset in the financial statements?
8. What is purchased goodwill?
9. Over what period should goodwill be amortised?
10. What treatment does SFRS(I) 3 prescribe for a gain on a bargain purchase?
Answers to Quick Quiz

1. Examples of costs that are excluded from the cost of inventories and are recognised as an expense as incurred are:
   (a) Abnormal amounts of wasted materials, labour or other production costs;
   (b) storage costs (except costs which are necessary in the production process before a further production stage);
   (c) administrative overheads not incurred to bring inventories to their present location and condition; and
   (d) selling costs.

2. False

3. • Research costs are written off as an expense as they are incurred
   • Development costs qualify as intangible assets if specific recognition criteria are met.

4. When the surplus is eventually realised or as the asset is used by the entity (ie transfer of the difference between the amortisation based on the revalued carrying amount and the amortisation based on historical cost) (SFRS(I) 1-38 (87)).

5. Over its useful life, where this is finite, otherwise it is not amortised but instead tested for impairment annually.

6. The difference between the net disposal proceeds and the carrying value.

7. The value of goodwill is usually inherent in the business but does not have an ‘objective’ value.

8. The aggregate of the difference between the fair value of the consideration transferred plus any non-controlling interest, and the fair value of the net assets acquired.

9. Goodwill should not be amortised, instead it is tested annually for impairment.

10. Before recognising a gain, measurement procedures for assets and liabilities and for consideration must be reviewed.

Answers to Questions

9.1 Inventory valuation

<table>
<thead>
<tr>
<th>Units</th>
<th>Cost</th>
<th>NRV</th>
<th>Lower</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item A</td>
<td>300</td>
<td>175</td>
<td>173</td>
<td>173</td>
</tr>
<tr>
<td>Item B</td>
<td>250</td>
<td>60</td>
<td>65</td>
<td>60</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

9.2 Recognition criteria

At the end of 20X3, the production process is recognised as an intangible asset at a cost of $10,000. This is the expenditure incurred since the date when the recognition criteria were met, that is 1 December 20X3. The $90,000 expenditure incurred before 1 December 20X3 is expensed, because the recognition criteria were not met. It will never form part of the cost of the production process recognised in the statement of financial position.
9.3 Downward valuation

In this example, the downward valuation of $500 can first be set against the revaluation surplus of $400. The revaluation surplus will be reduced to 0 and a charge of $100 made as an expense in profit or loss in 20X4.

9.4 Useful life

Factors to consider would include the following.

(a) Legal protection of the brand name and the control of the entity over the (illegal) use by others of the brand name (ie control over pirating)

(b) Age of the brand name

(c) Status or position of the brand in its particular market

(d) Ability of the management of the entity to manage the brand name and to measure activities that support the brand name (eg advertising and PR activities)

(e) Stability and geographical spread of the market in which the branded products are sold

(f) Pattern of benefits that the brand name is expected to generate over time

(g) Intention of the entity to use and promote the brand name over time (as evidenced perhaps by a business plan in which there will be substantial expenditure to promote the brand name)

9.5

(a) Research

- Activities aimed at obtaining new knowledge
- The search for applications of research findings or other knowledge
- The search for product or process alternatives
- The formulation and design of possible new or improved product or process alternatives

(b) Development

- The evaluation of product or process alternatives
- The design, construction and testing of pre-production prototypes and models
- The design of tools, jigs, moulds and dies involving new technology
- The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production

Project 1 expenditure, including that relating to previous years, should all be written off in 20X2, as there is now considerable doubt as to the profitability of the project.

Since commercial production has started under project 2 the expenditure previously deferred should now be amortised. This will be done over the estimated life of the product, as stated in the question.

Project 3: the development costs must be deferred.

Since project 4 is not expected to be profitable its development costs should not be deferred.

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2 (extract)

<table>
<thead>
<tr>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
</tr>
<tr>
<td>Intangible assets</td>
</tr>
<tr>
<td>Development costs (Note 2)</td>
</tr>
</tbody>
</table>

Note 2: Development costs.
Notes:

1  Accounting policies

Research and development

Research and development expenditure is written off as incurred, except that development costs incurred on an individual project are carried forward when their future recoverability can be foreseen with reasonable assurance. Any expenditure carried forward is amortised over the period of sales from the related project.

2  Development costs

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance brought forward 1 January 20X2</td>
<td>730</td>
<td></td>
</tr>
<tr>
<td>Development expenditure incurred during 20X2 (41 + 71 + 27)</td>
<td>139</td>
<td></td>
</tr>
<tr>
<td>Development expenditure amortised during 20X2 (450/5)</td>
<td>(90)</td>
<td></td>
</tr>
<tr>
<td>Development expenditure written off during 20X2 (321 + 27)</td>
<td>(348)</td>
<td></td>
</tr>
<tr>
<td>Balance carried forward 31 December 20X2</td>
<td>(299)</td>
<td></td>
</tr>
</tbody>
</table>

Note: SFRS(I) 1-38 does not permit the inclusion of market research in deferred development costs. Market research costs might, however, be carried forward separately under the accruals principle.

Workings

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>B/F</td>
<td>280</td>
<td>450</td>
<td></td>
<td></td>
<td>730</td>
</tr>
<tr>
<td>Salaries etc</td>
<td>35</td>
<td>60</td>
<td>20</td>
<td></td>
<td>115</td>
</tr>
<tr>
<td>Overheads</td>
<td>2</td>
<td></td>
<td>3</td>
<td></td>
<td>5</td>
</tr>
<tr>
<td>Materials etc</td>
<td>3</td>
<td>11</td>
<td>4</td>
<td></td>
<td>18</td>
</tr>
<tr>
<td>Patents etc</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>C/F</td>
<td></td>
<td>(360)</td>
<td>(71)</td>
<td></td>
<td>(431)</td>
</tr>
<tr>
<td>Amortised/Written off</td>
<td>321</td>
<td>90*</td>
<td></td>
<td>27</td>
<td>438</td>
</tr>
</tbody>
</table>

* Note: An alternative basis for amortisation would be:

\[
\frac{20}{180} \times 450 = 50
\]

The above basis is more prudent, however, in this case.

9.6 Characteristics of goodwill

Goodwill may be distinguished from other intangible non-current assets by reference to the following characteristics.

(a) It is incapable of realisation separately from the business as a whole.

(b) Its value has no reliable or predictable relationship to any costs which may have been incurred.

(c) Its value arises from various intangible factors such as skilled employees, effective advertising or a strategic location. These indirect factors cannot be valued reliably.

(d) The value of goodwill may fluctuate widely according to internal and external circumstances over relatively short periods of time.

(e) The assessment of the value of goodwill is highly subjective.
It could be argued that, because goodwill is so different from other intangible non-current assets it does not make sense to account for it in the same way. Therefore, the capitalisation and amortisation treatment would not be acceptable. Furthermore, because goodwill is so difficult to value, any valuation may be misleading, and it is best eliminated from the statement of financial position altogether. However, there are strong arguments for treating it like any other intangible non-current asset. This issue remains controversial.
SFRS(I) 1-36 covers the **impairment of assets**. This is a standard which you have covered before, therefore you must ensure that you are very familiar with its requirements.

**Topic list**

1 SFRS(I) 1-36 *Impairment of Assets*
2 Identification of an impairment
3 Impairment test
4 Accounting for an impairment loss
5 Cash-generating units
6 Disclosure
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment of Assets</td>
<td></td>
</tr>
<tr>
<td>Apply, explain or evaluate the circumstances in which an impairment test of assets is necessary.</td>
<td>3</td>
</tr>
<tr>
<td>Calculate, explain and evaluate the adequacy of an impairment test for all classes of assets under the relevant accounting standard appropriate to that class of asset.</td>
<td>3</td>
</tr>
<tr>
<td>Evaluate sensitivity of an impairment analysis to the exercise of professional judgment, use of assumptions and critical estimates.</td>
<td>3</td>
</tr>
<tr>
<td>Identify and explain a cash-generating unit and explain the need for impairment testing to be done at the smallest cash-generating unit level.</td>
<td>3</td>
</tr>
<tr>
<td>Allocate impairment losses for a cash-generating unit.</td>
<td>3</td>
</tr>
<tr>
<td>Emerging Trends</td>
<td></td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments.</td>
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</tr>
</tbody>
</table>

ESSENTIAL READING

SFRS(I) 1-36 Impairment of Assets

1 SFRS(I) 1-36 *Impairment of Assets*

SECTION INTRODUCTION

SFRS(I) 1-36 *Impairment of Assets* covers a controversial topic affecting goodwill as well as a range of tangible and intangible non-current assets.

The basic principle underlying SFRS(I) 1-36 is relatively straightforward. If an asset's carrying amount in the accounts is higher than the amount that an entity could recover through use or sale of the asset (its 'recoverable amount') the asset is judged to have suffered an impairment loss. The carrying amount should therefore be reduced to the recoverable amount and an *impairment loss* recognised.

The main accounting issues to consider are therefore as follows.

(a) How is it possible to *identify when* an impairment loss may have occurred?
(b) How should the *recoverable amount* of the asset be measured?
(c) How should an 'impairment loss' be *reported in the accounts*?

Before we address these issues, we will consider which assets SFRS(I) 1-36 deals with and the definitions given within the standard.
1.1 Scope

SFRS(I) 1-36 applies to all assets, except:
(a) Inventories under SFRS(I) 1-2 *Inventories*
(b) Contract assets and assets arising from costs to obtain or fulfil a contract that are recognised in accordance with SFRS(I) 15 *Revenue from Contracts with Customers*
(c) Deferred tax assets under SFRS(I) 1-12 *Income Taxes*
(d) Assets arising under SFRS(I) 1-19 *Employee Benefits*
(e) Financial assets within the scope of SFRS(I) 9 *Financial Instruments*
(f) Investment property measured at fair value under SFRS(I) 1-40 *Investment Property*
(g) Non-current assets classified as held for sale in accordance with SFRS(I) 5 *Non-current Assets Held for Sale and Discontinued Operations*
(h) Biological assets related to agricultural activity that are measured at fair value less costs of disposal under SFRS(I) 1-41 *Agriculture*
(i) Deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of SFRS(I) 4 *Insurance Contracts*, or, where SFRS(I) 17 *Insurance Contracts* is adopted, contracts within the scope of the standard that are assets.

This is because those standards already have rules for recognising and measuring impairment.
The standard therefore applies to assets such as property, plant and equipment, intangible assets and goodwill.

1.2 Definitions

SFRS(I) 1-36 provides a number of definitions including the following:

**KEY TERMS**

**Impairment Loss** The amount by which the carrying amount of an asset or cash-generating unit exceeds its recoverable amount.

**Carrying Amount** is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and any accumulated impairment losses thereon.

**Recoverable Amount** of an asset or cash-generating unit is the higher of its fair value less costs of disposal and its value in use.

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

**Costs of Disposal** are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.

**Value in Use** is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.  

(SFRS(I) 1-36)
SECTION SUMMARY

SFRS(I) 1-36 applies to all assets other than those within the scope of another standard which deals with the impairment of a specific type of asset. An impairment loss is the amount by which the carrying amount of an asset or cash-generating unit exceeds its recoverable amount.

2 Identification of an impairment

SECTION INTRODUCTION

SFRS(I) 1-36 suggests how an impairment may be identified.

SFRS(I) 1-36 requires an entity to carry out a review of its assets at end of each reporting period, to assess whether there are indications of impairment to any assets.

The standard suggests a number of indications that an impairment has occurred, some of these are from external sources of information and others from internal sources.

External sources of information include:

(a) A fall in the asset's market value that is more significant than would normally be expected from passage of time over normal use
(b) A significant change in the technological, market, legal or economic environment of the business in which the assets are employed
(c) An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use
(d) The carrying amount of the entity's net assets being more than its market capitalisation

Internal sources of information include:

(a) Evidence of obsolescence or physical damage
(b) Significant changes with an adverse effect on an entity which have or will change the expected use or useful life of an asset
(c) Evidence that the asset's economic performance is worse than expected
(d) Cash flows to operate or maintain an asset are significantly more than those originally budgeted
(e) Cash flows or profit flowing from the asset are significantly lower than budgeted
(f) A significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset
(g) Operating losses or net cash outflows for the asset, when current period amounts are aggregated with budgeted amounts for the future

The standard also suggests that dividends received from an investment in a subsidiary, associate or joint venture are an indication of impairment when:

(a) Evidence is available that the carrying amount of the investment in the separate financial statements exceeds the investee's net assets in the consolidated financial statements.
(b) The dividend exceeds the total comprehensive income of the investee in the period in which the dividend is declared.
SFRS(I) 1-36 is clear that these lists are not exhaustive, and an entity may identify other indications that an asset is impaired.

The presence of indicators of impairment will not necessarily mean that an entity has to calculate the recoverable amount of the asset. A previous calculation may have shown that an asset's recoverable amount was significantly greater than its carrying amount.

**SECTION SUMMARY**

SFRS(I) 1-36 requires an entity to carry out a review of its assets at each year-end, to assess whether there are indications of impairment to any assets. Indications may be internal or external.

### 3 Impairment test

**SECTION INTRODUCTION**

SFRS(I) 1-36 provides guidelines on how often an impairment test should be performed and how it is performed.

#### 3.1 Frequency and timing of impairment tests

An impairment test is required for all assets when there is an indication of impairment at the reporting date.

Some assets must be tested annually even if there are no indications of impairment:

- **Tested annually**
  - Intangible assets with indefinite useful life
  - Intangible assets not yet available for use
  - Goodwill acquired in a business combination

Intangible assets requiring an annual impairment test may be tested at any time during the reporting period providing that the test is performed at the same time each year.

Where an intangible asset which requires annual testing is recognised in a reporting period, it must be tested for impairment before the end of that reporting period.

#### 3.2 Performing an impairment test

An asset is impaired when its carrying amount exceeds its recoverable amount. An impairment test therefore involves establishing recoverable amount and comparing this with carrying amount.

It should be noted that even where an asset's recoverable amount exceeds its carrying amount and there is no impairment, the fact that indicators of impairment were identified may suggest that estimates related to the asset such as residual value and useful life require revising.
3.2.1 SFRS(I) 1-36 relief provisions

Where an impairment test is required because indicators of impairment are present, SFRS(I) 1-36 contains ‘relief provisions’ which remove the need to estimate recoverable amount at the date of the impairment test. Instances where a previously calculated recoverable amount can be used include the following:

(a) Where a previously calculated recoverable amount is significantly greater than carrying amount and no events have occurred that would eliminate that difference

(b) Where previous analysis has identified that an asset’s recoverable amount is not sensitive to the particular indication of impairment that has been identified

In these cases there is no impairment.

Example

Orchard Trade Ltd has identified that an asset with a remaining useful life of 30 years may be impaired as a result of an increase in the short-term market interest rates in the period. The asset's value in use was its recoverable amount at the time of the last impairment test.

The discount rate used by Orchard Trade Ltd to calculate the recoverable amount (value in use) of the asset is unlikely to be affected by an increase in short-term market rates because the asset has a 30-year remaining useful life.

3.3 Measuring the recoverable amount of the asset

This section considers how recoverable amount is determined in instances where a full impairment test is required. We have already defined recoverable amount.

\[
\text{Recoverable amount} = \text{higher of} \left\{ \begin{array}{l}
\text{Fair value} \\
\text{less costs of disposal} \\
\text{Value in use} \\
\end{array} \right.
\]

Where it is not possible to establish the fair value less costs of disposal, value in use is the recoverable amount.

3.4 Fair value less costs of disposal

Fair value for the purpose of impairment testing is established by reference to SFRS(I) 13. SFRS(I) 1-36 itself provides no additional guidance.

The standard does, however provide guidance on what costs are included as ‘costs of disposal’. Examples of costs of disposal are:

- Legal costs
- Stamp duty
- Costs of removing the asset
- Direct incremental costs in bringing an asset into condition for its sale

Costs of disposal do not, however, include termination benefits, restructuring or reorganisation expenses.
3.5 Value in use

Value in use is established by:

- Estimating future cash inflows and outflows from the use and ultimate disposal of the asset, and
- Applying an appropriate discount rate to these cash flows.

The calculation should reflect:

- An estimate of the future cash flows the entity expects to derive from the asset
- Expectations about possible variations in the amount and timing of future cash flows
- The time value of money
- The price for bearing the uncertainty inherent in the asset
- Other factors that would be reflected in pricing future cash flows from the asset

3.5.1 Cash flows

Calculating a value in use calls for estimates of future cash flows, and the possibility exists that an entity might come up with over-optimistic estimates of cash flows. The SFRS(I) therefore states that future cash flow projections must:

(a) Be based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining life of the asset

(b) Be based on the most recent approved budgets which cover a maximum period of five years unless a longer period can be justified

(c) Exclude the effects of future restructuring or improving the asset's performance

Future cash flow projections beyond a five year period should be obtained by extrapolating short-term projections, using either a steady or declining growth rate for each subsequent year (unless a rising growth rate can be justified). The long-term growth rate applied should not exceed the average long term growth rate for the product, market, industry or country, unless a higher growth rate can be justified.

Future cash flow projections should include the following.

(a) Projections of cash inflows from continuing use of the asset

(b) Projections of cash outflows necessarily incurred to generate the cash inflows from continuing use of the asset

(c) Net cash flows received/paid on disposal of the asset at the end of its useful life

Estimates of future cash flows should exclude the following.

- Cash inflows/outflows from financing activities
- Income tax receipts/payments

The amount of net cash inflow/outflow on disposal of an asset at the end of its useful life shall be the amount that an entity expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the estimated costs of disposal.

Foreign currency future cash flows should be forecast in the currency in which they will arise and will be discounted using a rate appropriate for that currency. The resulting figure should then be translated into the reporting currency at the spot rate at the date of the value in use calculation. Future exchange rates should not be estimated when determining value in use.

3.5.2 Discount rate

The discount rate should be a current pre-tax rate (or rates) that reflects the current assessment of the time value of money and the risks specific to the asset.
Such a rate might be estimated from:

(a) The rate implicit in current market transactions for similar assets; or
(b) The weighted average cost of capital of a listed entity that has a single asset (or portfolio of assets) similar in terms of service potential and risks to the asset under review.

To avoid double counting, the discount rate should not include a risk weighting if the underlying cash flows have already been adjusted for risk.

Where an asset specific rate is not available, an appropriate discount rate must be estimated. The following can be used as a starting point:

- The entity’s weighted average cost of capital
- The entity’s incremental borrowing rate
- Other market borrowing rates

These must be adjusted to reflect the way that the market would assess specific risks associated with the asset’s estimated cash flows and to exclude risks that are not relevant to the asset or for which the cash flows have already been adjusted.

**Example**

Sembawang Manufacturing Ltd has a machine with a carrying amount of $249,000. Sembawang has identified that an economic slump may be an indicator of the impairment of the machine and has therefore initiated an impairment review. The fair value of the machine is $263,000 and the following costs of disposal have been identified:

- Legal costs $10,000
- Costs of removal $15,000
- Redundancy payment to machine operator $25,000

Future cash flow forecasts derived from the most recent budgets approved by management are:

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$75,000</td>
</tr>
<tr>
<td>2</td>
<td>$69,000</td>
</tr>
<tr>
<td>3</td>
<td>$59,000</td>
</tr>
<tr>
<td>4</td>
<td>$57,000</td>
</tr>
<tr>
<td>5</td>
<td>$54,000</td>
</tr>
</tbody>
</table>

An appropriate asset-specific pre-tax discount rate of 10% has been estimated by Sembawang Manufacturing.

Has an impairment occurred and if so what is the amount of the impairment loss?

**Solution**

- Carrying amount is $249,000
- Fair value less costs of disposal is $238,000 (263,000 – 10,000 – 15,000). The redundancy cost is not a ‘cost of disposal’.
- Value in use:

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow x (1/1.10)^n</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>75,000 x 1/1.10</td>
<td>68,182</td>
</tr>
<tr>
<td>2</td>
<td>69,000 x 1/1.10^2</td>
<td>57,025</td>
</tr>
<tr>
<td>3</td>
<td>59,000 x 1/1.10^3</td>
<td>44,328</td>
</tr>
<tr>
<td>4</td>
<td>57,000 x 1/1.10^4</td>
<td>38,932</td>
</tr>
<tr>
<td>5</td>
<td>54,000 x 1/1.10^5</td>
<td>33,530</td>
</tr>
<tr>
<td></td>
<td></td>
<td>241,997</td>
</tr>
</tbody>
</table>
- Recoverable amount is the higher of fair value less costs of disposal and value in use, so $241,997.
- This is less than carrying amount and therefore an impairment loss of $7,003 has arisen (249,000 – 241,997).

**SECTION SUMMARY**

An asset is impaired when its carrying amount exceeds its recoverable amount. Recoverable amount is the higher of fair value less costs of disposal and value in use. Value in use is the future expected cash flows associated with the asset discounted to present value.

4 Accounting for an impairment loss

**SECTION INTRODUCTION**

An impairment loss is recognised in profit or loss unless it reverses an upwards revaluation.

If the recoverable amount of an asset is lower than the carrying amount, the carrying amount should be reduced by the difference (ie the impairment loss) immediately. Recognition of the loss depends on the measurement model applied to the impaired asset:

- **Asset held under cost model**
  - Loss recognised in profit or loss

- **Asset held under fair value/valuation model**
  - Loss is a revaluation decrease in accordance with relevant standard

Eg For revalued PPE, loss recognised:
1. In OCI and charged against any revaluation surplus in respect of the asset
2. Any excess is recognised in profit or loss

**Example**

Pacific Bio Ltd, a Singapore company, owns property in Kuala Lumpur. The property is held under the SFRS(I) 1-16 revaluation model and has a carrying amount of $10.9 million at 30 September 20X3. On this date Pacific Bio conducted an impairment test on the property and found its value in use to be MYR23 million and its fair value less costs of disposal to be MYR21.5 million. The company has previously recognised a revaluation surplus in respect of the property and the balance on the revaluation surplus in equity is $1,656,750.

How is the impairment accounted for as at 30 September 20X3?

Exchange rate on 30 September 20X3: $1: 2.5MYR
Solution

- The recoverable amount is MYR23 million, being the higher of value in use and fair value less costs of disposal.
- The recoverable amount is translated to $9.2 million, therefore an impairment loss of $1.7 million is recognised.
- $1,656,750 reduces the revaluation surplus to nil and the balance of $43,250 is recognised in profit or loss ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revaluation surplus (other comprehensive income)</td>
<td>Property</td>
</tr>
<tr>
<td>1,656,750</td>
<td>1,700,000</td>
</tr>
<tr>
<td>Profit or loss</td>
<td></td>
</tr>
<tr>
<td>43,250</td>
<td></td>
</tr>
</tbody>
</table>

To recognise the impairment loss on the revalued property.

Note in practice foreign currency issues would also need to be considered.

Example

A company that extracts natural gas and oil has a drilling platform in the Caspian Sea. It is required by legislation of the country concerned to remove and dismantle the platform at the end of its useful life. Accordingly, the company has included an amount in its accounts for removal and dismantling costs, and is depreciating this amount over the platform's expected life.

The company is carrying out an exercise to establish whether there has been an impairment of the platform.

(a) Its carrying amount in the statement of financial position is $3 million.

(b) The company has received an offer of $2.8 million for the platform from another oil company. The bidder would take over the responsibility (and costs) for dismantling and removing the platform at the end of its useful life.

(c) The present value of the estimated cash flows from the platform's continued use is $3.3 million.

(d) The carrying amount in the statement of financial position for the provision for dismantling and removal is currently $0.6 million.

At what amount should the drilling platform be measured in the statement of financial position, and what, if anything, is the impairment loss?

Solution

- Fair value less costs of disposal = $2.8m
- Value in use = PV of cash flows from use less the carrying amount of the provision = $3.3m – $0.6m = $2.7m
- Recoverable amount = Higher of these two amounts, ie $2.8m
- Carrying amount = $3m
- Impairment loss = $0.2m

Therefore (in $):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit or loss</td>
<td>Property, plant and equipment</td>
</tr>
<tr>
<td>200,000</td>
<td>200,000</td>
</tr>
</tbody>
</table>

To reduce the carrying amount to $2.8 million
4.1 Subsequent accounting for an impaired asset

Subsequent to an impairment loss, the depreciation (amortisation) charge on an asset is calculated based on the new carrying amount, residual value, if any, and the expected remaining useful life. Both the residual value and useful life may need to be reassessed.

Impaired assets must also be reviewed for further impairment where indications of impairment exist (or annually as required by SFRS(I) 1-36).

4.2 Reversal of an impairment loss

An impairment loss recognised for an asset other than goodwill can be reversed if, and only if, there has been a change in the estimates used to determine recoverable amount since the last impairment loss was recognised.

An impairment loss can only be reversed to the extent that the increased carrying amount of the asset does not exceed the amount that the asset would have been carried at had there been no initial impairment.

The reversal of an impairment loss of a non-revalued asset is recognised immediately in profit or loss. The reversal of an impairment loss on a revalued asset is recognised in profit or loss to the extent that the impairment loss on the same asset was initially recognised in profit or loss; any excess is recognised in other comprehensive income and increases the revaluation surplus for that asset.

Depreciation (amortisation) of the asset is subsequently based on the new carrying amount, estimated residual value and estimated useful life.

Example

Geylang Solutions Ltd acquired its head office on 1 January 20W8 at a cost of $5.0 million (excluding land). Geylang Solutions’ policy is to depreciate property on a straight-line basis over 50 years with a zero residual value.

On 31 December 20X2 (after five years of ownership) Geylang Solutions revalued the non-land element of its head office to $8.0 million. The company does not transfer annual amounts out of revaluation surplus as assets are used: this is in accordance with the permitted treatment in SFRS(I) 1-16 Property, Plant and Equipment.

At the end of December 20X7 localised flooding occurred and the recoverable amount of the non-land element of the head office property fell to $2.9 million.

Subsequently the head office building continued to be depreciated on the same basis as before.

By 31 December 20X9 a property boom meant that the estimates used to assess recoverable amount changed and the recoverable amount of the non-land element of the property was $4.2 million.

Required

What accounting entries are required in December 20X7 and December 20X9 in respect of the carrying amount of the property?

Solution

December 20X7

An impairment that reverses a previous revaluation should be recognised through other comprehensive income to the extent of the amount in the revaluation surplus for that same asset. Any remaining amount is recognised through profit or loss. Thus:

- The carrying amount at 31 December 20X2 is 45/50 × $5.0m = $4.5m
- The revaluation surplus created is $3.5m (ie $8.0m – $4.5m)
- The carrying amount at 31 December 20X7 is 40/45 × $8.0m = $7.1m
10: Impairment of assets | PART D ACCOUNTING FOR ASSETS AND LIABILITIES

- The recoverable amount at 31 December 20X7 is $2.9m
- The total impairment charge is $4.2m (ie $7.1m – $2.9m)
- Of this, $3.5m is a reversal of the revaluation surplus, so only $0.7 million is recognised through profit or loss ($m):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other comprehensive income (revaluation surplus)</td>
<td>Property, plant and equipment</td>
</tr>
<tr>
<td>3.5</td>
<td>4.2</td>
</tr>
<tr>
<td>Profit or loss</td>
<td></td>
</tr>
<tr>
<td>0.7</td>
<td></td>
</tr>
</tbody>
</table>

To record the impairment of the head office

December 20X9

A reversal of an impairment loss is recognised in profit or loss to the extent that the impairment loss was originally recognised in profit or loss. Thereafter it is recognised in other comprehensive income.

- The carrying amount at 31 December 20X9 is $2.9m
- The recoverable amount on this date is $4.2m
- The carrying amount of the asset on 31 December 20X9 had an impairment not occurred in 20X7 would be $8m
- The recoverable amount had the impairment loss not taken place and therefore the asset can be restated to the recoverable amount
- The impairment loss is reversed by $1.445m ($4.2m – $2.755m)
- $0.7m of the impairment loss was previously recognised in profit or loss and therefore this amount of the increase in value is recognised in profit or loss
- The balance of $745,000 is recognised in other comprehensive income ($m):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>Other comprehensive income (revaluation surplus)</td>
</tr>
<tr>
<td>1.445</td>
<td>0.7</td>
</tr>
<tr>
<td>Profit or loss</td>
<td></td>
</tr>
<tr>
<td>0.7</td>
<td></td>
</tr>
</tbody>
</table>

To record the reversal of the impairment of the head office

4.3 Compensation for impairment

Any compensation from third parties for impairments shall be included in profit or loss when the compensation becomes receivable. SFRS(I) 1-16 makes it clear that this is a separate economic event to the impairment and so should be accounted for separately.

SECTION SUMMARY

An impairment loss is normally recognised immediately in profit or loss. To the extent that a revaluation surplus exists in respect of an asset, any impairment loss on that asset is first charged to other comprehensive income and reduces the revaluation surplus with any excess loss charged to profit or loss. An impairment loss on an asset other than goodwill can be reversed where estimates used to determine recoverable amount have changed.
5 Cash-generating units

SECTION INTRODUCTION

Where the recoverable amount of a single asset cannot be estimated, the impairment test must be performed for the cash-generating unit (CGU) to which the asset belongs.

SFRS(I) 1-36 goes into great detail about the important concept of cash-generating units. As a basic rule, the recoverable amount of an asset should be calculated for the asset individually. However, there will be occasions when it is not possible to estimate such a value for an individual asset, particularly in the calculation of value in use. This is because cash inflows and outflows cannot be attributed to the individual asset.

If it is not possible to calculate the recoverable amount for an individual asset, the recoverable amount of the asset's cash-generating unit should be measured instead.

Identification of an asset's cash-generating unit involves judgment.

KEY TERM

A CASH-GENERATING UNIT is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. (SFRS(I) 1-36 paragraph 6)

5.1 Determining cash-generating units

An entity's CGUs are likely to reflect the way in which management monitors and makes decisions about the business. This may be by product line or type of service.

The number of CGUs within one entity will depend on the nature of the business and how the company is structured. Judgment must be exercised but the basic principle that a CGU has cash inflows which are largely independent of the entity's other cash inflows should be adhered to. Note that the standard makes no mention of cash outflows and therefore these are irrelevant.

SFRS(I) 1-36 gives the following additional guidance on establishing CGUs:

(a) If an active market exists for the output produced by an asset (or group of assets), that asset (or group of assets) is a CGU even where some or all of the output is used internally.

(b) Cash-generating units must be identified consistently from period to period unless a change is justified.

Examples of cash-generating units

SFRS(I) 1-36 provides the following two examples of CGUs:

(a) A mining company owns a private railway that it uses to transport output from one of its mines. The railway has no market value other than as scrap, and it is impossible to identify any separate cash inflows with the use of the railway itself. Consequently, if the mining company suspects an impairment in the value of the railway, it should treat the mine as a whole as a cash-generating unit, and measure the recoverable amount of the mine as a whole.

(b) A bus company has an arrangement with a town's authorities to run a bus service on five routes in the town. Separately identifiable assets are allocated to each of the bus routes, and cash inflows and outflows can be attributed to each individual route. Four routes are running at a profit and one is running at a loss. The bus company suspects that there is an impairment of assets on the loss-making route. However, the company will be unable to close the loss-making route, because it is
under an obligation to operate all five routes, as part of its contract with the local authority. Consequently, the company should treat all five bus routes together as a cash-generating unit, and calculate the recoverable amount for the bus company as a whole.

SFRS(I) 1-36 includes a number of Illustrative Examples which you should review.

**Question 10.1**  
Minimart belongs to a retail store chain Maximart. Minimart makes all its retail purchases through Maximart's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring Minimart's cashiers and salespeople) are decided by Maximart. Maximart also owns five other stores in the same city as Minimart (although in different neighbourhoods) and 20 other stores in other cities. All stores are managed in the same way as Minimart. Minimart and four other stores were purchased five years ago and goodwill was recognised.

What is the cash-generating unit for Minimart?

**Question 10.2**  
Asia Publishing Ltd owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognised as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognised as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment.

What is the cash-generating unit for Asia Publishing Ltd?

**5.2 Impairment testing a CGU**

An impairment test is conducted for a CGU in the same way as for an individual asset:

1. Carrying amount of the CGU is established
2. Recoverable amount is calculated as the higher of value in use and fair value less costs of disposal
3. An impairment loss is recognised where carrying amount exceeds recoverable amount.

The key point is that both carrying amount and recoverable amount for a CGU are calculated based on the same assets and liabilities.

**5.2.1 Carrying amount of a CGU**

In some cases assets are allocated to a CGU as they are clearly directly attributable to that CGU. In other cases, assets, in particular goodwill and ‘corporate assets’ such as a head office are company-wide or relate to a number of CGUs. We shall deal with this issue in the next sections of the chapter.

Liabilities are only allocated to the carrying amount of a CGU where the recoverable amount cannot be determined without consideration of the liability ie if a potential buyer were required to assume the liability.

The carrying amount of net working capital (eg receivables and payables) is only included in a CGU if the related cash flows are included in the calculation of recoverable amount.
Example

Fourways Co is made up of four cash-generating units. All four units are being tested for impairment. How are assets and liabilities allocated and the test performed?

Solution

(a) Property, plant and equipment and separate intangibles would be allocated to the cash-generating units as far as possible.

(b) Current assets such as inventories, receivables and prepayments would be allocated to the relevant cash-generating units.

(c) Liabilities (e.g. payables) would be deducted from the net assets of the relevant cash-generating units.

(d) The net figure for each cash-generating unit resulting from this exercise would be compared to the relevant recoverable amount, computed on the same basis.

5.3 Goodwill and impairment

Goodwill acquired in a business combination (SFRS(I) 3) does not generate cash flows independently of other assets and therefore it must be tested for impairment as part of a CGU rather than as a standalone asset. Goodwill is allocated to each of the acquirer's cash-generating units (or groups of cash-generating units) that are expected to benefit from the synergies of the combination.

5.3.1 Allocating goodwill to cash-generating units

Each unit to which goodwill is allocated should:

(a) Represent the lowest level within the entity at which the goodwill is monitored for internal management purposes

(b) Not be larger than a reporting segment determined in accordance with SFRS(I) 8 Operating Segments. Note that this applies even where an entity is not within the scope of SFRS(I) 8.

It may be impractical to complete the allocation of goodwill before the first reporting date after a business combination, particularly if the acquirer is accounting for the combination for the first time using provisional values. The initial allocation of goodwill must be completed before the end of the first reporting period beginning after the acquisition date.

5.3.2 Testing CGUs with goodwill for impairment

There are two situations to consider.

1. Where goodwill has been allocated to a cash-generating unit

2. Where it has not been possible to allocate goodwill to a specific cash-generating unit, but only to a group of CGUs

A cash-generating unit to which goodwill has been allocated is tested for impairment annually. The carrying amount of the unit, including goodwill, is compared with the recoverable amount. If the carrying amount of the unit exceeds the recoverable amount, the entity must recognise an impairment loss.

Where goodwill relates to a cash-generating unit but has not been allocated to that unit, the unit is tested for impairment by comparing its carrying amount (excluding goodwill) with its recoverable amount. The entity must recognise an impairment loss if the carrying amount exceeds the recoverable amount.
5.3.3 Non-controlling interest

If there is a non-controlling interest in a cash-generating unit to which goodwill has been allocated, and the non-controlling interest is measured as a proportion of net assets, then adjustment must be made to the carrying amount of the CGU before the impairment test takes place.

This is to ensure that we compare like with like:

- The recoverable amount includes the value of all goodwill in the CGU
- The carrying amount includes only the parent share of goodwill

Therefore the carrying amount of the goodwill allocated to the CGU is grossed up to include the goodwill attributable to the non-controlling interest.

Note that this is not an issue where the non-controlling interest is measured at fair value since recognised goodwill is then full goodwill ie including goodwill attributable to the NCI.

Example

On 1 January 20X4 a parent acquires an 80% interest in a subsidiary for $1,600,000, when the identifiable net assets of the subsidiary are $1,500,000. The non-controlling interest is measured as a proportion of the net assets of the subsidiary. The subsidiary is a cash-generating unit.

At 31 December 20X4, the recoverable amount of the subsidiary is $1,000,000. The carrying amount of the subsidiary's identifiable assets is $1,350,000.

Calculate the impairment loss at 31 December 20X4.

Solution

At 31 December 20X4 the cash-generating unit consists of the subsidiary's identifiable net assets (carrying amount $1,350,000) and goodwill of $400,000 (1,600,000 – 80% × $1,500,000). Goodwill is grossed up to reflect the 20% non-controlling interest.

<table>
<thead>
<tr>
<th>Goodwill</th>
<th>Net assets</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$’000</td>
<td>$’000</td>
<td>$’000</td>
</tr>
<tr>
<td>Carrying amount</td>
<td>400</td>
<td>1,350</td>
</tr>
<tr>
<td>Non-controlling interest (20/80 × 400)</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Recoverable amount</td>
<td>1,850</td>
<td></td>
</tr>
<tr>
<td>Impairment loss</td>
<td>(1,000)</td>
<td>850</td>
</tr>
</tbody>
</table>

5.4 Corporate assets

Corporate assets are group or divisional assets such as a head office building or a research centre. Essentially, corporate assets are assets that do not generate cash inflows independently from other assets, hence their carrying amount cannot be fully attributed to a cash-generating unit under review.

In testing a cash-generating unit for impairment, an entity should identify all the corporate assets that relate to the cash-generating unit.

(a) If a portion of the carrying amount of a corporate asset can be allocated to the unit on a reasonable and consistent basis, the entity compares the carrying amount of the unit (including the portion of the asset) with its recoverable amount.

(b) If a portion of the carrying amount of a corporate asset cannot be allocated to the unit on a reasonable and consistent basis, the entity:

   (i) Compares the carrying amount of the unit (excluding the asset) with its recoverable amount and recognises any impairment loss
(ii) Identifies the smallest group of cash-generating units that includes the cash-generating unit to which the asset belongs and to which a portion of the carrying amount of the asset can be allocated on a reasonable and consistent basis

(iii) Compares the carrying amount of that group of cash-generating units (including the portion of the asset allocated to the group of units) with the recoverable amount of the group of units and recognises any impairment loss

Example

(You may wish to study Chapter 20 Operating Segments before considering this example.)

The financial controller of The Seacroft Group, an unlisted group that makes and sells furniture, is assessing the Group's cash-generating units for the purposes of impairment testing. She believes that each of the four subsidiaries of the group is an independent cash-generating unit since each gave rise to goodwill. She also believes that the parent company includes three cash-generating units, being the sales and marketing department, the production department and the finance function. Each of the subsidiaries presents internal management reports to the Chief Executive Officer (CEO) who is responsible for allocating resources to subsidiaries and assessing their performance. One subsidiary, Moorcroft presents two internal management reports to the CEO of the Group, one being in respect of its office furniture division and the other in respect of its home furniture division.

Advise the financial controller whether she is correct in her assessment of the cash-generating units of The Seacroft Group.

Solution

Parent company

A cash-generating unit (CGU) is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash flows from other assets or groups of assets. The financial controller has identified three CGUs within the parent company being the sales and marketing department, production department and finance function. Neither the sales and marketing department nor finance function are capable of generating independent cash flows; they are likely to be cost centres rather than profit centres. Therefore they are not three separate CGUs. The sales and marketing department, production department and finance function together may be considered to be a CGU. Alternatively, if the sales and marketing department and finance function are both group functions providing services to all group companies these may be corporate assets and may require allocating to CGUs. In this case the parent company's production department is likely to be a CGU in its own right.

Subsidiaries

Goodwill is allocated to the carrying amount of subsidiaries; SFRS(I) 1-36 states that each unit to which goodwill is allocated should represent the lowest level at which goodwill is monitored for management purposes and not be larger than an SFRS(I) 8 operating segment. Whilst the other three subsidiaries do appear to be separate CGUs, Moorcroft does not represent a single CGU; it includes two CGUs. Financial information is supplied to the Chief Operating Decision Maker (the CEO) in respect of the office and home furniture divisions and therefore each of these is a separate operating segment.

5.4.1 Allocating a corporate asset to CGUs

Where possible it is normally most appropriate to allocate shared assets by reference to the extent to which they are used by each CGU. In practice, however, most entities will allocate them based on the carrying amounts of the other net assets of the CGU. Alternative acceptable methods include pro-rating based on turnover, profit or sales volume of CGUs. Any other approach may be used provided that it reflects the way in which the corporate asset contributes to each CGU.
Example

Queenstown Trading Ltd has identified 3 CGUs within its business all of which use a central distribution centre with a carrying amount of $4.5 million. This is to be allocated to the CGUs based on sales volume. The following information is relevant:

<table>
<thead>
<tr>
<th>Sales volume</th>
<th>Carrying amount of allocated assets</th>
<th>Recoverable amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>CGU A</td>
<td>9m units $1.8m</td>
<td>$2.5m</td>
</tr>
<tr>
<td>CGU B</td>
<td>22.5m units $4.3m</td>
<td>$6.8m</td>
</tr>
<tr>
<td>CGU C</td>
<td>13.5m units $4.1m</td>
<td>$5.2m</td>
</tr>
</tbody>
</table>

What impairment losses, if any, have the CGUs suffered?

Solution

<table>
<thead>
<tr>
<th>In $</th>
<th>Carrying amount of allocated assets</th>
<th>Distribution centre allocation*</th>
<th>Total</th>
<th>Recoverable amount</th>
<th>Impairment loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>CGU A</td>
<td>1,800,000</td>
<td>900,000</td>
<td>2,700,000</td>
<td>2,500,000</td>
<td>200,000</td>
</tr>
<tr>
<td>CGU B</td>
<td>4,300,000</td>
<td>2,250,000</td>
<td>6,550,000</td>
<td>6,800,000</td>
<td>–</td>
</tr>
<tr>
<td>CGU C</td>
<td>4,100,000</td>
<td>1,350,000</td>
<td>5,450,000</td>
<td>5,200,000</td>
<td>250,000</td>
</tr>
</tbody>
</table>

* CGU A 9/(9+22.5+13.5) × $4.5m
CGU B 22.5/(9+22.5+13.5) × $4.5m
CGU C 13.5/(9+22.5+13.5) × $4.5m

5.5 Summary diagram

We have considered in detail what may be included in the carrying amount and recoverable amount of a CGU. The key point is that the same underlying assets and liabilities must be included in both. The following summary provides an overview of the items that may be included:

- Directly attributable assets
- Goodwill (grossed up)
- Share of corporate assets
- Liabilities
- Net working capital

5.6 Allocating an impairment loss to a CGU

An impairment loss should be recognised for a cash-generating unit if (and only if) the recoverable amount for the cash-generating unit is less than the carrying amount in the statement of financial position for all the assets in the unit. When an impairment loss is recognised for a cash-generating unit, the loss should be allocated between the assets in the unit in the following order/priority:

(a) First to the goodwill allocated to the cash-generating unit
(b) Then to all other assets in the cash-generating unit, on a pro rata basis

In allocating an impairment loss, the carrying amount of an asset should not be reduced below the highest of:

- Its fair value less costs of disposal
- Its value in use (if determinable)
- Zero

Any remaining amount of an impairment loss should be recognised as a liability if required by other SFRS(I)s.
Example

A company has acquired another business for $4.5 million: tangible assets are valued at $4.0 million and goodwill at $0.5 million.

An asset with a carrying amount of $1 million is destroyed in a terrorist attack. The asset was not insured. The loss of the asset, without insurance, has prompted the company to estimate whether there has been an impairment of assets in the acquired business and what the amount of any such loss is. The recoverable amount of the business without the destroyed asset is measured at $3.1 million.

Solution

The destroyed asset is first considered as an individual asset. It has a recoverable amount of zero and therefore the full carrying amount is written off and an impairment loss of $1 million recognised.

The carrying amount of the remaining business (a single cash-generating unit) is therefore reduced to $3.5 million ($3.0m tangible assets + $0.5m goodwill).

The recoverable amount of the remaining business is measured as $3.1 million. There has therefore been an impairment loss of $0.4 million (carrying amount $3.5m – recoverable amount $3.1m).

The impairment loss of $0.4 million is recognised as an expense in profit or loss and is allocated to goodwill, reducing the carrying amount of goodwill to $0.1 million.

Since the impairment loss is absorbed by goodwill no loss is allocated to the remaining tangible assets of the business.

5.7 Reversal of an impairment loss in a CGU

As we saw earlier in the chapter, an impairment loss recognised in prior years should be reversed if, and only if, there has been a change in the estimates used to determine recoverable amount since the last impairment loss was recognised.

This also applies to CGUs with the following rules applicable:

1. The carrying amount of any individual asset cannot increase above the lower of its recoverable amount and the carrying amount of the asset net of depreciation (amortisation) had no impairment previously been recognised.
2. An impairment relating to goodwill cannot be reversed.

Question 10.3

Reversal of impairment loss

A cash-generating unit comprising a factory, plant and equipment etc and associated purchased goodwill becomes impaired because the product it makes is overtaken by a technologically more advanced model produced by a competitor. The recoverable amount of the cash-generating unit falls to $60 million, resulting in an impairment loss of $80 million, allocated to goodwill $40 million, to patent (with no market value ie no active market exist) $20 million and the remaining $20 million to tangible non-current assets as follows.

<table>
<thead>
<tr>
<th>Carrying amounts</th>
<th>Carrying amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>$m</td>
<td>$m</td>
</tr>
<tr>
<td><strong>before impairment</strong></td>
<td><strong>after impairment</strong></td>
</tr>
<tr>
<td>Goodwill</td>
<td>40</td>
</tr>
<tr>
<td>Patent (with no market value)</td>
<td>20</td>
</tr>
<tr>
<td>Tangible long-term assets</td>
<td>80</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>140</strong></td>
</tr>
</tbody>
</table>
After three years, the entity makes a technological breakthrough of its own, and the recoverable amount of the cash-generating unit increases to $90 million. The carrying amount of the tangible long-term assets had the impairment not occurred would have been $70 million.

Required

Explain the accounting for the reversal of the impairment loss.

5.8 Further practice questions

Question 10.4

Orchid Machines International Ltd is testing for impairment two subsidiaries which have been identified as separate cash-generating units.

Some years ago Orchid Machines International acquired 80% of Drummond Ltd for $600,000 when the fair value of Drummond's identifiable assets was $400,000. As Drummond's policy is to distribute all profits by way of dividend, the fair value of its identifiable net assets remained at $400,000 on 31 December 20X7. The impairment review indicated Drummond's recoverable amount at 31 December 20X7 to be $520,000.

Some years ago Orchid Machines International also acquired 85% of Mandalay Ltd for $800,000 when the fair value of Mandalay's identifiable net assets was $700,000. Goodwill of $205,000 ($800,000 – ($700,000 × 85%)) was recognised. As Mandalay's policy is to distribute all profits by way of dividend, the fair value of its identifiable net assets remained at $700,000 on 31 December 20X7. The impairment review indicated Mandalay's recoverable amount at 31 December 20X7 to be $660,000.

It is Orchid Machines International group policy to value the non-controlling interest using the proportion of net assets method.

Required

Determine the following amounts in respect of Orchid Machines International's consolidated financial statements at 31 December 20X7 according to SFRS(I) 1-36 Impairment of Assets.

(a) The carrying amount of Drummond's assets to be compared with its recoverable amount for impairment testing purposes

(b) The carrying amount of goodwill in respect of Drummond after the recognition of any impairment loss

(c) The carrying amount of the non-controlling interest in Mandalay after recognition of any impairment loss

Question 10.5

Assume that the facts relating to the acquisition of Drummond are the same as above, except that it is Orchid Machines International group's policy to value the non-controlling interest on the acquisition of Drummond at fair value. The fair value of the non-controlling interest in Drummond at acquisition was $100,000.

Required

Determine the following amounts in respect of Orchid Machines International's consolidated financial statements at 31 December 20X7 according to SFRS(I) 1-36 Impairment of Assets.

(a) The carrying amount of Drummond's assets to be compared with its recoverable amount for impairment testing purposes

(b) The carrying amount of goodwill in respect of Drummond after the recognition of any impairment loss
SECTION SUMMARY

Where an individual asset cannot be tested for impairment because its recoverable amount cannot be estimated, the CGU to which it belongs is tested. Goodwill is allocated to the CGU or CGUs which are expected to benefit from the synergies of the combination; corporate assets are allocated to CGUs on a reasonable and consistent basis. Any impairment is allocated first to the goodwill of a CGU and then to all other assets (within the scope of SFRS(I) 1-36) on a pro rata basis.

6 Disclosure

SECTION INTRODUCTION

SFRS(I) 1-36 calls for substantial disclosure about impairment of assets.

The main disclosure requirements are as follows:

- Amounts of impairments or reversals recognised in profit or loss in the period
- Amounts of impairments or reversals recognised in other comprehensive income
- The events and circumstances leading to the impairment or reversal
- A description of the nature of the asset or CGU
- Any changes in the aggregation of assets into CGUs
- Whether recoverable amount is value in use or fair value less costs of disposal
- The basis used to determine fair value less costs of disposal where this is recoverable amount
- The discount rate used in the calculation of value in use when it is recoverable amount

In addition, where a CGU includes goodwill or intangible assets with indefinite useful lives, further detail of the calculation of recoverable amount is required.

You should review the disclosures provided in SFRS(I) 1-36.

SECTION SUMMARY

SFRS(I) 1-36 requires disclosure of impairments recognised in the period and details of the impairments together with an explanation of how recoverable amount was calculated.
**Chapter Roundup**

### SFRS(I) 1-36

**Impairment**

- **Test if indicators of impairment:**
  - Internal indicators
  - External indicators

- **Annual test for:**
  - Goodwill
  - Intangibles with indefinite life
  - Intangibles not available for use

#### Assets

- Impaired if carrying amount > recoverable amount
- Recognise loss
  - In profit or loss if asset held under cost model
  - In OCI to extent revaluation surplus exists

#### Cash-generating units

- Smallest identifiable group of assets that generates independent cash flows
  - Allocate goodwill
  - Allocate corporate assets

- Impaired if carrying amount > recoverable amount
- Recoverable amount higher of
  - FV less costs of disposal
  - Value in use
    - Discounted future cash flows

- Recognise loss:
  1. Against goodwill
  2. Against other assets in scope of SFRS(I) 1-36 on pro rata basis

Reverse only if change in estimates used to determine recoverable amount (not goodwill)
Quick Quiz

1. Define an impairment.
2. How is value in use of an asset calculated?
3. How is fair value established for the purpose of estimating fair value less costs of disposal?
4. What is a cash-generating unit?
5. How are corporate assets dealt with in an impairment review?
Answers to Quick Quiz

1. A fall in the value of an asset, so that its recoverable amount is now less than its carrying amount.
2. The present value of estimated future cash flows generated by the asset, including its estimated net disposal value (if any).
3. In accordance with SFRS(I) 13
4. The smallest identifiable group of assets for which independent cash flows can be identified and measured.
5. They are allocated to CGUs on a reasonable and consistent basis.

Answers to Questions

10.1 Cash-generating unit 1

In identifying Minimart's cash-generating unit, an entity considers whether, for example:

(a) Internal management reporting is organised to measure performance on a store-by-store basis.
(b) The business is run on a store-by-store profit basis or on a region/city basis.

All Maximart's stores are in different neighbourhoods and probably have different customer bases. So, although Minimart is managed at a corporate level, Minimart generates cash inflows that are largely independent from those of Maximart's other stores. Therefore, it is likely that Minimart is a cash-generating unit.

10.2 Cash-generating unit 2

It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis.

Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent one from another and that each magazine title is a separate cash-generating unit.

10.3 Reversal of impairment loss

The reversal of the impairment loss is recognised to the extent that it increases the carrying amount of the tangible non-current assets to what it would have been had the impairment not taken place (SFRS(I) 1-36 para 117), i.e., a reversal of the impairment loss of $10m is recognised as if there were no previous impairment and the tangible non-current assets written back to $70m. Reversal of the impairment is not recognised in relation to the goodwill and patent because the effect of the external event that caused the original impairment has not reversed – the original product is still overtaken by a more advanced model.
10.4 Orchid Machines International

(a) $750,000
(b) $96,000
(c) $99,000

Workings

(a)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount of Drummond’s net assets</td>
<td>$400,000</td>
</tr>
<tr>
<td>Goodwill recognised on acquisition</td>
<td>$280,000</td>
</tr>
<tr>
<td>$600,000 – (80% × $400,000)</td>
<td></td>
</tr>
<tr>
<td>Notional NCI goodwill ($280,000 × 20/80)</td>
<td>$70,000</td>
</tr>
<tr>
<td></td>
<td>$750,000</td>
</tr>
</tbody>
</table>

(b) The impairment loss is the total $750,000 less the recoverable amount of $520,000 = $230,000. Under SFRS(I) 1-36 this is firstly allocated against the $350,000 goodwill. (As the impairment loss is less than the goodwill, none is allocated against identifiable net assets.) As only the goodwill relating to Orchid Machines International is recognised, only its 80% share of the impairment loss is recognised:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount of goodwill</td>
<td>$280,000</td>
</tr>
<tr>
<td>Impairment (80% × 230,000)</td>
<td>(184,000)</td>
</tr>
<tr>
<td>Revised carrying amount of goodwill</td>
<td>$96,000</td>
</tr>
</tbody>
</table>

(c)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount of Mandalay’s net assets</td>
<td>$700,000</td>
</tr>
<tr>
<td>Recognised goodwill</td>
<td>$205,000</td>
</tr>
<tr>
<td>Notional NCI goodwill (15/85 × $205,000)</td>
<td>$36,176</td>
</tr>
<tr>
<td>Recoverable amount</td>
<td>(660,000)</td>
</tr>
<tr>
<td>Impairment loss</td>
<td>$281,176</td>
</tr>
</tbody>
</table>

Allocated to:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognised and notional goodwill</td>
<td>$241,176</td>
</tr>
<tr>
<td>Other net assets</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

Therefore the non-controlling interest is ($700,000 – $40,000) × 15% = $99,000.

As the non-controlling interests does not include goodwill, only the impairment allocated to other net assets is included here.
10.5 Drummond

(a) $700,000  
(b) $120,000

**Workings**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consideration transferred</strong></td>
<td>$600,000</td>
</tr>
<tr>
<td><strong>Fair value of NCI</strong></td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Fair value of net assets acquired</strong></td>
<td>$400,000</td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
<td>$300,000</td>
</tr>
<tr>
<td><strong>Carrying amount of Drummond's net assets</strong></td>
<td>$400,000</td>
</tr>
<tr>
<td><strong>Goodwill recognised on acquisition</strong></td>
<td>$300,000</td>
</tr>
</tbody>
</table>

(b) The impairment loss is the total $700,000 less the recoverable amount of $520,000 = $180,000. Under SFRS(I) 1-36 this is first allocated against the $300,000 goodwill. (As the impairment loss is less than the goodwill, none is allocated against identifiable net assets.)

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Carrying amount of goodwill</strong></td>
<td>$300,000</td>
</tr>
<tr>
<td><strong>Impairment</strong></td>
<td>$(180,000)</td>
</tr>
<tr>
<td><strong>Revised carrying amount of goodwill</strong></td>
<td>$120,000</td>
</tr>
</tbody>
</table>

In the equity of the group statement of financial position, the retained earnings will be reduced by the parent's share of the impairment loss on the full goodwill, ie $144,000 (80% × $180,000) and the NCI reduced by the NCI's share, ie $36,000 (20% × $180,000).

In the statement of profit or loss and other comprehensive income, the impairment loss of $180,000 will be charged as an operating expense. As the impairment loss relates to the full goodwill of the subsidiary, so it will reduce the NCI in the subsidiary's profit for the year by $36,000 (20% × $180,000).
Leasing transactions are extremely common in business and you will often come across them in both your business and personal capacity. SFRS(I) 16 Leases has replaced the earlier standard, SFRS(I) 1-17 Leases, in your syllabus. The standard becomes effective for accounting periods beginning on or after 1 January 2019 in practice and this will result in significant changes to lessee accounting. A single accounting model is now applied by all lessees, with very limited exceptions, whilst the lessor accounting treatment is largely unchanged from that of SFRS(I) 1-17.
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measurement and Reporting (Liabilities)</strong></td>
<td></td>
</tr>
<tr>
<td>Apply, explain and evaluate accounting standards for major classes of liabilities, insofar as they affect initial recognition, measurement (including initial measurement and subsequent re-measurement), classification and disclosure, and de-recognition from an entity's statement of financial position.</td>
<td>3</td>
</tr>
<tr>
<td><strong>Specific applications</strong></td>
<td></td>
</tr>
<tr>
<td>Apply the relevant accounting treatment on the following classes of liabilities:</td>
<td>3</td>
</tr>
<tr>
<td>• Leases and contracts with the characteristics of leases.</td>
<td></td>
</tr>
<tr>
<td><strong>Emerging Trends</strong></td>
<td></td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments.</td>
<td>1</td>
</tr>
</tbody>
</table>

**ESSENTIAL READING**

SFRS(I) 16 Leases, Illustrative Examples: SFRS(I) 16 Leases

1 **SFRS(I) 16 Leases**

**SECTION INTRODUCTION**

SFRS(I) 16 replaces SFRS(I) 1-17 for accounting periods beginning on or after 1 January 2019. Earlier application is permitted.

A lease is a contract between a lessor and a lessee for the right to use a specific asset. The lessor retains ownership of the asset but conveys the right of the use of the asset to the lessee for an agreed period of time in return for the payment of specified rentals. This type of arrangement is common for many entities and it is important that the users of financial statements have a complete and understandable picture of an entity's leasing activities.

SFRS(I) 16 Leases sets out the principles for the recognition, measurement, presentation and disclosure of leases. Unlike its predecessor, SFRS(I) 1-17 Leases, SFRS(I) 16 adopts a single accounting model relevant to all lessees, which, in most cases, requires the recognition of an asset and corresponding liability. This is a change from the previous standard, which did not always require the recognition of an asset and liability in respect of a lease arrangement; therefore SFRS(I) 16 addresses criticisms that the previous standard did not always provide a faithful representation of leasing transactions. The SFRS(I) 1-17 accounting model for lessors is largely retained in SFRS(I) 16, with the result that lessee and lessor accounting models in SFRS(I) 16 are asymmetrical i.e they do not mirror one another.

This chapter explains the lease accounting model applicable to lessees, the accounting treatment that should be applied by lessors (which is largely unchanged from the treatment required by SFRS(I) 1-17) and accounting for sale and leaseback transactions.
1.1 Scope of SFRS(I) 16

SFRS(I) 16 applies to all leases, including arrangements whereby an entity leases an asset from one entity and leases it to another (a sublease). The standard does not apply to:

(a) Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
(b) Leases of biological assets within the scope of SFRS(I) 1-41 Agriculture held by a lessee;
(c) Service concession arrangements within the scope of SFRS(I) INT 12 Service Concession Arrangements;
(d) Licences of intellectual property granted by a lessor within the scope of SFRS(I) 15 Revenue from Contracts with Customers;
(e) Rights held by a lessee under licensing arrangements within the scope of SFRS(I) 1-38 Intangible Assets for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

SFRS(I) 16 may be, but is not required to be, applied to leases of intangible assets other than those in (e) above.

SFRS(I) 16 may, as a practical expedient, be applied to a portfolio of leases with similar characteristics rather than to individual leases, providing that the effects on the financial statements would not differ materially from applying SFRS(I) 16 to individual leases.

1.2 Definitions

SFRS(I) 16 provides a substantial number of definitions. Some of these are provided below; others are provided in the relevant sections of the chapter.

**KEY TERMS**

**LEASE** A contract, or part of contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

**UNDERLYING ASSET** An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

**LESSOR** An entity that provides the right to use an underlying asset for a period of time in exchange for consideration.

**LESSEE** An entity that obtains the right to use an underlying asset for a period of time in exchange for consideration.

**SUBLEASE** A transaction for which an underlying asset is released by a lessee (intermediate lessor) to a third party and the lease (head lease) between the head lessor and lessee remains in effect.

**LEASE TERM** The non-cancellable period for which the lessee has the right to use an underlying asset, together with both:

(a) periods covered by an option to extend the lease if the lessee is reasonably certain to extend that option; and

(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

**COMMENCEMENT DATE OF THE LEASE** is the date on which a lessor makes an underlying asset available for use by a lessee.

**INCEPTION DATE OF THE LEASE** is the earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.

(SFRS(I) 16)
288 11: Leases  |  PART D ACCOUNTING FOR ASSETS AND LIABILITIES

SECTION SUMMARY

SFRS(I) 16 Leases replaces SFRS(I) 1-17 with effect from 1 January 2019; it adopts a single accounting model relevant to all lessees, whilst retaining the requirements of SFRS(I) 1-17 for lessor accounting. Earlier application is permitted.

2 Lease contracts

SECTION INTRODUCTION

A lease contract gives the right to control the use of an identified asset for a period of time in exchange for consideration.

A contract may be a lease or it may contain a lease; whether a contract is or contains a lease must be assessed at the inception of the 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:

<table>
<thead>
<tr>
<th>Right to control</th>
<th>Identified asset</th>
<th>Period of time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present if an entity has the right to:</td>
<td>Must be explicitly or implicitly specified in the contract.</td>
<td>May be described in terms of use of the underlying asset eg the number of units produced by a leased machine.</td>
</tr>
<tr>
<td>• Obtain substantially all economic benefits from the use of the asset, within the parameters of the lease and</td>
<td>• May be a portion of an asset (eg a floor of a property) if physically distinct.</td>
<td>• Lease may only be for a portion of the term of the contract (if the right to control an asset exists for only part of the term).</td>
</tr>
<tr>
<td>• Direct the use of the asset</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2.1 Restrictions on economic benefits

In order to have the right to control an asset, an entity must obtain substantially all economic benefits from the use of the asset. Where use is restricted by the terms of the contract, only the economic benefits within the parameters of those terms should be considered.

2.2 Substitution of identified asset

A supplier may have a substantive right to substitute the identified asset during the period of use. A substantive right exists where:

• The supplier has the practical ability to substitute alternative assets throughout the period of use; and
• The supplier would benefit economically from doing so.

In this case the contract is not a lease as the asset is not controlled by the lessee.
Question 11.1

Finance lease

Geylang Communications Ltd (GPL) enters into the following contracts in the year ended 31 December 20X7:

1. A 24-month contract with Truckitt, a haulage firm, for the use of a specified delivery truck. Truckitt will operate and maintain the truck and can impose contractual restrictions on the use of the truck, eg prohibiting its use for the transportation of flammable materials. Beyond those restrictions, GPL decides what goods are transported on the truck and on what routes it operates and when.

2. A contract with VHL to obtain the use of a specified car for three years for the use of a director. Consideration is to be provided at $16,000 per annum. The contract restricts the use of the car, with a specified maximum mileage of 15,000 miles.

3. A contract with Advanced Telecommunications Ltd (ATL) to obtain the use of 15% of the capacity of ACL's fibre-optic cable network to enable GCL to deliver superfast broadband to its customers. The contract price is $1 million per annum for an initial term of eight years.

Explain whether these arrangements are (or contain) a lease.

2.3 Components of a contract

SFRS(I) 16 requires that a party to a contract that contains a lease separates the constituent parts of the contract at its inception and allocate the contract price to the components of the contract.

The parts of a contract may include:

<table>
<thead>
<tr>
<th>Lease components</th>
<th>Non-lease components</th>
<th>Activities that are not a component of the contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eg contract to use a car</td>
<td>Eg contract for the maintenance of the car</td>
<td>Eg contract to pay upfront administrative fees</td>
</tr>
</tbody>
</table>

2.3.1 Lease components

If a single contract conveys the right to use more than one underlying asset, there may be more than one lease component within the contract. The right to use an underlying asset is a separate lease component if:

1. The lessee can benefit from the underlying asset either on its own or together with other resources that are readily available to the lessee (including goods or services that are sold or leased separately), and

2. The underlying asset is not highly dependent on or interrelated with the other underlying assets in the contract.

2.3.2 Activities that are not a component of a lease

Activities such as administrative or initial fees are not a component of a lease; for the purpose of applying SFRS(I) 16, no contract consideration is allocated to these activities. Instead total consideration is allocated to lease and non-lease components.

2.4 Allocating consideration to components of a contract

Total contract consideration must be allocated between the components of a contract in order to apply the relevant accounting; SFRS(I) 16 provides guidance on the allocation of consideration for both lessees and lessors.

2.4.1 Allocation of consideration – lessees

Lessees should consider non-lease components in aggregate ie they are not separated for the purpose of applying SFRS(I) 16.
Lessees should therefore allocate contract consideration between lease components and the total non-lease component. This allocation is made on the basis of relative standalone prices of each lease component and the aggregate non-lease component.

Standalone prices are determined by reference to the price that the lessor, or another supplier, would charge an entity for a component separately. If an observable standalone price is not available, such a price can be estimated provided that the use of observable information is maximised.

Having allocated consideration, SFRS(I) 16 is applied to account for lease components and other relevant standards are applied to account for the non-lease component.

Example

Pacific Laundry Ltd, a commercial laundry, enters into a three-year lease contract to obtain use of a commercial washing machine and commercial dryer for use at its new premises within a hotel belonging to one of its main corporate customers. The terms of the contract provide for an annual service of the machines to be carried out by the manufacturer-lessee; an initial fee of $10,000 is payable and annual payments of $60,000 are required.

Pacific Laundry Ltd has established the following standalone prices for the lease of the washer, the lease of the dryer and their servicing:

<table>
<thead>
<tr>
<th>Lease ($)</th>
<th>Servicing ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Washer</td>
<td>85,000</td>
</tr>
<tr>
<td>Dryer</td>
<td>75,000</td>
</tr>
<tr>
<td></td>
<td>160,000</td>
</tr>
<tr>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td></td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td>35,000</td>
</tr>
</tbody>
</table>

Identify the components of the contract and explain how the contract consideration is allocated to them.

Solution

The contract contains lease and non-lease components as well as an initial fee that is not a component of the contract.

The contract conveys the right to use two underlying assets – a washer and a dryer. These are two separate lease components because the washer and dryer are not highly dependent on one another. Although the dryer is used after items have been washed, it could be used in conjunction with any other washer, or after handwashing items. Equally the washer does not depend on the dryer as items could be hung to air-dry.

The contract also provides for the servicing of the washer and the servicing of the dryer. These are non-lease components and are therefore joined together to be a single non-lease component.

The contract therefore contains two lease components and a single non-lease component. The total contract consideration of $190,000 ($10,000 + ($60,000 × 3)) is allocated to these three components.

The total of the standalone prices is $195,000, meaning that a discount is provided in the contract. The $190,000 is allocated to the components of the contract as follows:

<table>
<thead>
<tr>
<th>Lease of washer</th>
<th>Lease of dryer</th>
<th>Servicing</th>
</tr>
</thead>
<tbody>
<tr>
<td>$(85,000/195,000 × 190,000)</td>
<td>$(75,000/195,000 × 190,000)</td>
<td>$(35,000/195,000 × 190,000)</td>
</tr>
<tr>
<td>$82,821</td>
<td>$73,077</td>
<td>$34,102</td>
</tr>
</tbody>
</table>

2.4.2 Practical expedient – lessees

Lessees may elect not to separate lease and non-lease components and instead account for each lease component and any related non-lease component together as a lease component. This will have the effect that the initial measurement of the asset and related liability recognised in respect of a lease arrangement is increased.
This election is made by class of underlying asset, however it is not available in respect of embedded derivatives that must be separated from a host contract in line with SFRS(I) 9.

**2.4.3 Allocation of consideration – lessors**

A lessor should apply SFRS(I) 15 *Revenue from Contracts with Customers* criteria for the allocation of the transaction price to performance obligations in order to allocate consideration to components of a contract. This ensures that entities that are both a lessor and a seller of goods achieve consistency when accounting for both, and there is no reporting advantage to leasing rather than selling or vice versa.

**SECTION SUMMARY**

A lease contract gives the right to control the use of an identified asset for a period of time in exchange for consideration. Lease contracts may include both lease and non-lease components. These should be separated and consideration allocated to them. The following flowchart reproduced from SFRS(I) 16 summarises the steps involved in assessing whether a contract is, or contains, a lease:

![Flowchart](image-url)
3 Lessee accounting

SECTION INTRODUCTION

SFRS(I) 16 introduces a single accounting model that is relevant to all leases with limited exceptions.

Lessees must apply a single lease accounting model to all leases with the exception of short-term leases and leases for underlying assets of a low value. In these cases, simplified accounting may be applied. This is explained in section 3.2.

3.1 Definitions

SFRS(I) 16 provides a number of definitions that are relevant to lessee accounting:

**KEY TERMS**

**RIGHT-OF-USE ASSET** An asset that represents a lessee’s right to use an underlying asset for the lease term.

**LEASE PAYMENTS** Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

(a) Fixed payments (including any in-substance fixed payments), less any lease incentives;

(b) Variable lease payments that depend on an index or a rate;

(c) The exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and

(d) Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

**VARIABLE LEASE PAYMENTS** The portion of payments made by a lessee to a lessor for the right to use an underlying asset during the lease term that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

**LEASE INCENTIVES** Payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.

**LESSEE’S INCREMENTAL BORROWING RATE** The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

**RESIDUAL VALUE GUARANTEE** A guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount.

(SFRS(I) 16)
3.2 Simplified accounting

A lessee may apply simplified accounting in two situations:
1. A short-term lease
2. A lease for an underlying asset of low value

A short-term lease is a lease with a term of 12 months or less. Leases that contain purchase options cannot be treated as short-term leases regardless of their term.

‘Low value’ is not explicitly defined in SFRS(I) 16. The relevant value is that when the asset is new and the low value is on a per asset basis; simplified accounting can be applied to numerous identical assets which together have a high value as long as each asset is individually of low value eg tablet computers or small items of office furniture.

If a lessee subleases (or expects to sublease) an asset, the head lease does not qualify as a lease of a low value asset.

3.2.1 Accounting treatment

Lease payments are recognised as an expense on either a straight-line basis over the lease term or another systematic basis. The lessee shall apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

3.2.2 Election

An entity wishing to apply simplified accounting must elect to do so:
- In the case of short term leases the election is for a particular class of underlying asset.
- In the case of low-value assets, the election is on a lease by lease basis.

Question 11.2

On 1 March 20X7 Sentosa Designs Ltd (SDL) leased a cutting machine with a fair value of $135,000 on a two year lease. Lease payments are $2,000 per calendar month, payable in advance. In addition SDL were required to pay fees of $5,000 at the start of the lease. SDL has an option to terminate the agreement after 12 months without penalty and management of SDL believe that they are likely to exercise this option.

Explain how the lease should be accounted for and calculate the amount to be recognised in the financial statements in the year ended 31 October 20X7.

3.3 Lessee accounting model

At the commencement of the lease, a lessee should recognise:
- A right-of-use asset, which represents the ability to use the underlying asset for the lease term; and
- A lease liability, which represents the lessee's obligation to make lease payments to the lessor.

SFRS(I) 16 provides guidance on how each of these is initially measured and the subsequent accounting treatment.

3.3.1 Lease liability – initial measurement

The initial measurement of the lease liability is considered in the first place, as this also forms the basis of the measurement of the right-of-use asset.

The lease liability is initially measured at the present value of future lease payments. The discount rate is the rate implicit in the lease or where this cannot be determined, the lessee's incremental borrowing rate as defined in section 3.1 above.
Lease payments may include the following elements:

<table>
<thead>
<tr>
<th>Condition for inclusion</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed payments less lease incentives receivable</td>
<td>If fixed in substance (ie where there is no true variability because payments are linked to an event with no genuine possibility of non-occurrence)</td>
</tr>
<tr>
<td>Variable payments</td>
<td>If payments depend on a rate or index (but not where they depend on future performance or use of the asset)</td>
</tr>
<tr>
<td>Exercise price of a purchase option</td>
<td>If lessee reasonably certain to exercise option</td>
</tr>
<tr>
<td>Penalties to terminate the lease</td>
<td>If the lease term reflects the lessee exercising an option to terminate the lease</td>
</tr>
<tr>
<td>Amounts payable under residual value guarantees</td>
<td></td>
</tr>
</tbody>
</table>

Any payments in respect of non-lease components in a contract (see section 2.3) are excluded from the calculation of the lease liability unless the practical expedient is applied (see section 2.3.2).

Where variable lease payments that depend on a rate or index are included in the measurement of a lease liability, they are initially measured based on the index or rate at the commencement of the lease.

Variable lease payments that are excluded from the initial measurement of the lease liability are recognised in profit or loss in the period in which the event or condition that triggers those payments occurs.

**Example**

Orchard Ornamental Fish Ltd (OOF) enters into a 6 year contract on 1 May 20X6 to acquire the use of a water aeration system. The terms of the lease contract require annual payments in advance of $6,000. Lease payments will increase every year on the basis of the increase in the Singapore Consumer Price Index (CPI) in the previous 12 months. The CPI at the commencement date is 99. The interest rate implicit in the lease is not readily determinable; OOF’s incremental borrowing rate is 6%.

How is the lease liability initially measured?

**Solution**

At the commencement of the lease the liability is measured based on the current CPI ie it is measured based on 6 annual payments of $6,000. These are discounted at OOF’s incremental borrowing rate of 6%:

<table>
<thead>
<tr>
<th>Payment</th>
<th>Discount factor</th>
<th>Present value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 May 20X6</td>
<td>6,000</td>
<td>1</td>
</tr>
<tr>
<td>1 May 20X7</td>
<td>6,000</td>
<td>1/1.06</td>
</tr>
<tr>
<td>1 May 20X8</td>
<td>6,000</td>
<td>1/1.06²</td>
</tr>
<tr>
<td>1 May 20X9</td>
<td>6,000</td>
<td>1/1.06³</td>
</tr>
<tr>
<td>1 May 20Y0</td>
<td>6,000</td>
<td>1/1.06⁴</td>
</tr>
</tbody>
</table>

Lease liability | 26,791 |
Example

Rainbow Botanic Ltd (RBL) enters into a lease contract to obtain the use of a potting machine for use in its nurseries for four years. The terms of the contract require a payment at the start of the lease on 1 August 20X5 and subsequent payments in advance on 1 August 20X6, 20X7 and 20X8. The first payment is $15,000 and subsequent payments increase by the rate of SIBOR. At 1 August 20X5 SIBOR is 1%. The interest rate implicit in the lease is 5%.

How is the lease liability initially measured?

Solution

At the commencement of the lease the liability is measured based on the current SIBOR of 1% ie each annual payment is expected to increase by 1%. Payments at discounted at the 5% implicit interest rate

<table>
<thead>
<tr>
<th>Payment</th>
<th>Discount factor</th>
<th>Present value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 August 20X5</td>
<td>1</td>
<td>$15,000</td>
</tr>
<tr>
<td>1 August 20X6</td>
<td>1/1.05</td>
<td>$14,429</td>
</tr>
<tr>
<td>1 August 20X7</td>
<td>1/1.05²</td>
<td>$13,879</td>
</tr>
<tr>
<td>1 August 20X8</td>
<td>1/1.05³</td>
<td>$13,351</td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td>$56,659</td>
</tr>
</tbody>
</table>

Question 11.3

Noon Consumables Ltd (NCL) leased a manufacturing machine on 1 June 20X6 for a period of five years. The terms of the lease contract required NCL to pay a fixed annual amount of $50,000, in advance, and an additional payment at the end of each year based on the output of the machine. The additional payment is calculated as $10 for each unit of output produced, with a minimum annual additional payment of $10,000. On average NCL’s expected output is 1,100 units per annum. NCL’s incremental borrowing rate is 4%.

Explain how the lease liability is initially measured.

3.3.2 Right-of-use asset – initial measurement

A right-of-use asset is initially measured at cost, calculated as:

\[ \text{Cost of right-of-use asset} = \times \]

Initial direct costs are the incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained. They may include commissions, legal fees, the costs of negotiating lease terms, the costs of arranging collateral and payments made to existing tenants to obtain the lease.

Estimated dismantling and restoration costs are costs that the lessee is contractually required to pay in order to dismantle and remove the underlying asset, restore the site on which it is located and restore the underlying asset to the condition required at the end of the lease term, unless those costs are included within the cost of inventories. The obligation to pay these costs may arise
at the commencement of the lease or as the lease term progresses and the underlying asset is used. The amount is measured in accordance with SFRS(I) 1-37 and a corresponding provision is recognised.

- Lease incentives are defined in section 3.1 and may include up front cash payments to the lessee, a reimbursement of costs or an assumption of costs by the lessor. Lease incentives may or may not form part of the formal lease agreement.

**Question 11.4**

In arranging the lease contract for the manufacturing machine (see question 11.3), NCL paid the lessor a $5,000 arrangement fee on 25 May 20X6. The company also paid its legal advisers $3,000 to review the lease contract and provide advice on its terms. At the end of the lease term NCL is contractually obliged to dismantle the machine and transport it back to the lessor. The estimated present value of the cost of meeting this obligation on 31 May 20Y1 is $46,000.

What journal entries are required to recognise the right-of-use asset at 1 June 20X6?

### Solution

#### 3.3.3 Subsequent measurement of lease liability

The lease liability is subsequently:

- Decreased in each period of the lease term by payments made to the lessor;
- Increased in each period of the lease term by interest, calculated at a constant rate on the outstanding balance (the interest rate implicit in the lease or the lessee's incremental borrowing rate).

The lease liability may be remeasured due to a reassessment of the lease liability.

**Example**

Tanney Construction Ltd (TCL) entered into a four year lease agreement on 1 January 20X7 to obtain the use of a crane. The lease liability was initially measured at $223,400, based on an interest rate implicit in the lease of 5% and annual payments in advance of $60,000.

What journal entries are required in the year ended 31 December 20X7 in respect of the lease?

**Solution**

The lease is measured as follows subsequent to initial recognition

<table>
<thead>
<tr>
<th></th>
<th>B/f</th>
<th>Payment</th>
<th>C/f</th>
<th>Interest at 5%</th>
<th>C/F</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>31 Dec 20X7</td>
<td>223,400</td>
<td>(60,000)</td>
<td>163,400</td>
<td>8,170</td>
<td>171,570</td>
</tr>
<tr>
<td>31 Dec 20X8</td>
<td>171,570</td>
<td>(60,000)</td>
<td>111,570</td>
<td>5,579</td>
<td>117,149</td>
</tr>
<tr>
<td>31 Dec 20X9</td>
<td>117,149</td>
<td>(60,000)</td>
<td>57,149</td>
<td>2,851*</td>
<td>60,000*</td>
</tr>
<tr>
<td>31 Dec 20Y0</td>
<td>60,000</td>
<td>(60,000)</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>

*rounding difference of 6.

The journal entries in the year ended 31 December 20X7 are therefore ($):

- **DEBIT** Lease liability $60,000
- **CREDIT** Bank $60,000
  to recognise the lease payment on 1 January 20X7 ($)
- **DEBIT** Finance cost $8,170
- **CREDIT** Lease liability $8,170
  to recognise interest accruing on the outstanding liability in the year ended 31 December 20X7
3.3.4 Remeasurement of lease liability

Remeasurements reflect changes to lease payments; their accounting treatment depends on the reason for the change:

- Change in lease term
- Change in assessment of whether purchase option will be exercised
- Change in amounts expected to be paid under residual value guarantee
- Change in future variable lease payments due to change in rate or index

Discount revised lease payments using
unchanged discount rate

Discount revised lease payments using
revised discount rate (interest rate implicit in
lease for remainder of term, if readily
determinable, otherwise, lessee's incremental
borrowing rate at date of reassessment)

A remeasurement is recognised by increasing or decreasing the lease liability and making a corresponding adjustment to the right-of-use asset.

Example

In the example in section 3.3.1, Orchard Ornamental Fish Ltd (OOF) initially recognised a lease liability of $26,791 on 1 May 20X6, based on annual lease payments in advance of $6,000, which were due to increase each year on the basis of the increase in the Singapore Consumer Price Index (CPI) in the previous 12 months. The CPI at the commencement date was 99 and OOF's incremental borrowing rate 6%.

The CPI at 30 April 20X7 was 102. Explain how the lease liability is remeasured at this date.

Solution

The lease liability at 30 April 20X7 is measured at $22,038:

<table>
<thead>
<tr>
<th>B/f</th>
<th>Payment</th>
<th>C/f</th>
<th>Interest at 6%</th>
<th>C/f</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>30 April 20X7</td>
<td>26,791</td>
<td>(6,000)</td>
<td>20,791</td>
<td>1,247</td>
</tr>
</tbody>
</table>

Future lease payments will be $6,182 ($6,000 \times 102/99), and the lease liability is therefore remeasured:

<table>
<thead>
<tr>
<th>Payment</th>
<th>Discount factor</th>
<th>Present value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>1 May 20X7</td>
<td>6,182</td>
<td>1</td>
</tr>
<tr>
<td>1 May 20X8</td>
<td>6,182</td>
<td>1/1.06</td>
</tr>
<tr>
<td>1 May 20X9</td>
<td>6,182</td>
<td>1/1.06²</td>
</tr>
<tr>
<td>1 May 20Y0</td>
<td>6,182</td>
<td>1/1.06³</td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The lease liability (and therefore the right-of-use asset) both increase by $669 (22,707 – 22,038). This is achieved by ($):

DEBIT Right-of-use asset 669
CREDIT Lease liability 669
3.3.5 Subsequent measurement of right-of-use asset

A right-of-use asset is measured subsequent to initial recognition at cost less accumulated depreciation and impairment losses.

Depreciation is charged over the shorter of useful life of the underlying asset and the lease term, unless ownership transfers. Where ownership transfers, the depreciation period is the useful life of the underlying asset.

Two exceptions to this rule are:
1. If the underlying asset is an investment property and the lessee applies the fair value model to other investment properties, the asset must be measured in accordance with the SFRS(I) 1-40 fair value model.
2. If the underlying asset is property, plant and equipment and the lessee applied the revaluation model to that class of property, plant and equipment, the lessee may elect to measure the asset (and all other right-of-use assets in the same class) in accordance with the SFRS(I) 1-16 revaluation model.

3.3.6 Presentation in the financial statements

A right-of-use asset must be presented separately from other assets, and a lease liability must be presented separately from other liabilities in the statement of financial position.

A lease liability must be split between current and non-current amounts.

Depreciation must be presented separately from finance costs in the statement of profit or loss.

Question 11.5

Porcheron Property Ltd (PPL) entered into a five-year lease agreement on 1 July 20X6 to obtain the use of a construction vehicle with a useful life of seven years. The lease required payments in arrears of $7,000 per annum plus an additional $1,000 if a 4,000 miles per annum limit was exceeded. The implicit interest rate in the lease was 6%. PPL paid a $4,000 arrangement fee. The mileage limit was exceeded in the year ended 30 June 20X7 and PPL expected to exceed it in the year ended 30 June 20X8.

What journal entries are required in respect of the year ended 30 June 20X7 and what amounts are recognised in the financial statements in this year?

3.4 Modifications

A lease may be changed, or modified, during the lease term; SFRS(I) 16 provides the following definitions relating to modifications:

**KEY TERMS**

**LEASE MODIFICATION** A change in the scope of a lease, or the consideration for a lease that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one of more underlying assets, or extending or shortening the contractual lease term).

**EFFECTIVE DATE OF THE MODIFICATION** The date when both parties agree to a lease modification.
A lease modification is accounted for as a separate lease if:

1. The modification adds the right to use one or more underlying assets, and
2. The consideration for the lease increases by an amount commensurate with the standalone price relevant to the new underlying asset.

If a modification is accounted for as a separate lease, SFRS(I) 16 guidance as described in sections 3.2 and 3.3 applies.

If a modification is not accounted for as a separate lease, the lessee should:

- Identify separate components of the modified lease and allocate consideration to each
- Determine the lease term of the modified lease
- Remeasure the lease liability by discounting the revised lease payments using a revised discount rate

The remeasurement of the lease liability is recognised as follows:

(a) If the scope of the lease is decreased, the carrying amount of the right-of-use asset is also decreased to reflect this and the resulting gain or loss is recognised in profit or loss.

(b) For any other modification, the remeasurement is recognised by adjusting the carrying amount of the right-of-use asset.

**SECTION SUMMARY**

Unless simplified accounting is applied, at the commencement of a lease a right-of-use asset and corresponding lease liability are recognised by the lessee. The right-of-use asset is depreciated over the shorter of the lease term or the underlying asset's useful life (useful life if ownership transfers). Lease liability payments are split between interest and capital amounts using a constant periodic rate of interest in order to allocate the finance charge. If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset. Examples of low-value underlying assets can include tablet and personal computers, small items of office furniture and telephones.

4 **Lessor accounting**

**SECTION INTRODUCTION**

A lessor must determine whether a lease arrangement is an operating or a finance lease; the accounting treatment of each differs.

Lessor accounting does not mirror lessee accounting; instead a lessor must determine whether a lease is operating or finance in nature and account for it accordingly.
4.1 Definitions

SFRS(I) 16 provides a number of definitions that are specific to lessor accounting:

**KEY TERMS**

**OPERATING LEASE** A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

**FINANCE LEASE** A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

**FAIR VALUE** The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

**GROSS INVESTMENT IN THE LEASE** The sum of:
(a) The lease payments receivable by a lessor under a finance lease; and
(b) Any unguaranteed residual value accruing to the lessor.

**UNGUARANTEED RESIDUAL VALUE** That portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

**RESIDUAL VALUE GUARANTEE** A guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount.

**NET INVESTMENT IN THE LEASE** The gross investment in the lease discounted at the interest rate implicit in the lease.

**INTEREST RATE IMPLICIT IN THE LEASE** The rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.

**UNEARNED FINANCE INCOME** The difference between the gross investment in the lease and the net investment in the lease.

(SFRS(I) 16)

4.2 Risks and rewards

The classification of leases is therefore based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessee or the lessor. When we talk of **risks** here, we specifically mean the risks of ownership, not other types of risk. **Risks of ownership** include the possibility of losses from idle capacity or technological obsolescence, or variations in return due to changing economic conditions. The **rewards** are represented by the expectation of profitable operation over the asset's economic life, and also any gain from appreciation in value or realisation of a residual value.

There are some specific examples that suggest a finance lease such as the lessee receives ownership of the asset at the end of lease term, the lessee is expected to exercise the option to purchase, the lease term forms the majority of the asset's economic life, the asset is substantially loaned whereby the present value of minimum lease payment is almost all of the fair value of the asset and/or the asset is specialised for use by the lessee or entities authorised by the entity.

When a lease includes both **land and building** elements, the classification of each element as an operating or finance lease should be made separately. In determining whether the land element is an operating or finance lease, an important consideration is that land normally has an indefinite economic life.

Where the land element is immaterial (specifically the amount that would be recognised in respect of the lease were it classified as a finance lease), the land and buildings may be treated as a single unit for
classification purposes. Where this is the case, the economic life of the buildings is regarded as the economic life of the asset as a whole.

Lease classification is made at the inception of a lease and is only reassessed if there is a lease modification.

### 4.3 Operating leases

A lessor continues to recognise an asset that is leased out by way of an operating lease, and charges depreciation over the useful life of the asset. Lease income from the operating lease is recognised on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the time pattern in which the benefit from the leased asset is receivable.

The cost of incentives provided to the lessee is recognised as a reduction of the rental income over the lease term, generally on a straight-line basis.

If a lessor incurs costs to negotiate and arrange an operating lease, these costs are capitalised within the carrying amount of the underlying asset that is the subject of the lease. They are amortised over the lease term on the same basis as lease income.

#### Example

At 1 April 20X3, Kallang Truck Rental Pte Ltd owns a tow truck costing $75,000 with an economic life of ten years. The company entered into a two years lease agreement to lease the truck to Ubi Vehicle Recovery Pte Ltd for $10,000 per year. Kallang Truck Rental Pte Ltd continues to retain ownership of the tow truck and charges depreciation on a straight line basis, with no residual value.

What journal entries should Kallang Truck Rental Pte Ltd record in the year ended 31 March 20X4?

#### Solution

Kallang Truck Rental Pte Ltd recognises a non-current asset at historical cost less depreciation at year-end. The depreciation charge is $75,000/10 years = $7,500 and rental income of $10,000 is also recognised with appropriate disclosures.

The required journal entries in the year ended 31 March 20X4 are ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense</td>
<td>PPE (accumulated depreciation)</td>
</tr>
</tbody>
</table>

and

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash/receivable</td>
<td>Rental income</td>
</tr>
</tbody>
</table>

### 4.4 Finance leases

Although a lessor is the legal owner of an asset leased to another party under a finance lease, it has passed the risks and rewards of ownership to the lessee in return for a cash flow stream. As a result, the lessor derecognises the asset and instead recognises a receivable equal to the net investment in the lease. This is the present value of the aggregate of:

(a) The minimum lease payments receivable by the lessor; and

(b) Any unguaranteed residual amount accruing to the lessor.

An unguaranteed residual amount is that part of the residual value of a leased asset that is not assured or is guaranteed only by a party related to the lessor.

Initial direct costs incurred in negotiating and arranging the lease are added to the receivable.

Upon receipt of cash payments from the lessee, the amount received is allocated between the repayment of principal and finance income. The finance income should be recognised so as to generate a constant periodic rate of return on the outstanding net investment.
Example

Jurong Machinery Ltd leased a machine to a customer with effect from 1 January 20X4. The fair value of the machine at this date (equal to the net investment in the lease) was $14,875 and arrangement fees amounted to $125. The lease term was eight years and rentals of $2,750 are payable annually in advance. The interest rate implicit in the lease is 12.8%.

What amounts are recognised in Jurong Machinery's financial statements in the year ended 31 December 20X4 in respect of the lease?

Solution

The receivable is initially recognised as $14,875 + $125 = $15,000

Interest accrues to the receivable and payments reduce it as follows over the first two years of the term:

<table>
<thead>
<tr>
<th>y/e</th>
<th>Balance b/f</th>
<th>Repayment</th>
<th>Balance c/f</th>
<th>Finance income</th>
<th>Balance c/f</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>31.12.X4</td>
<td>15,000</td>
<td>(2,750)</td>
<td>12,250</td>
<td>1,568</td>
<td>13,818</td>
</tr>
<tr>
<td>31.12.X5</td>
<td>13,818</td>
<td>(2,750)</td>
<td>11,068</td>
<td>1,417</td>
<td>12,485</td>
</tr>
</tbody>
</table>

Therefore in the statement of financial position of Jurong Machine Ltd, a current and non-current asset are recognised.

Non-current asset: Net investment in finance lease $11,068
Current asset: Net investment in finance lease $2,750

Interest receivable of $1,568 is recognised in the statement of profit or loss and other comprehensive income.

4.4.1 Manufacturer and dealer leases

A manufacturer may offer a customer the choice of buying or leasing an asset. Where a customer leases an asset, the manufacturer's income should be split into:

- The profit or loss resulting from an outright sale of the relevant asset at fair value; and
- Finance income over the lease term.

If artificially low interest rates are quoted, the selling profit is restricted to that which would apply if a market rate of interest were charged.

SFRS(I) 16 requires that the selling profit or loss is recognised immediately. This is achieved at the commencement of the lease term by:

1. Recognising sales revenue at the fair value of the asset (or present value of minimum lease payments if lower)
2. Recognising a cost of sale equal to the cost (or carrying amount if different) of the leased asset less the present value of any unguaranteed residual value

Costs incurred by a manufacturer or dealer in arranging a finance lease are recognised as an expense at the commencement of the lease term.
SECTION SUMMARY

- Leases are classified as either finance or operating leases.
- A finance lease is a lease that transfers substantially all of the risks and rewards of ownership to the lessee; an operating lease is any other lease.
- The following diagram serves as a guide to help determine a finance or operating lease. The lease classification is, however, a management decision that should take into account all criteria mentioned in SFRS(I) 16:

![Diagram of lease classification criteria]

- A lease for land and buildings is split and the land and buildings elements classified separately in most instances.

A lessor recognises income on a straight-line basis in respect of an operating lease.

The lessor derecognises an asset leased out under a finance lease and instead recognises a receivable – the net investment in the lease.

5 Sale and leaseback transactions

SECTION INTRODUCTION

Sale and leaseback transactions involve an entity selling an asset and then leasing it back.

In a sale and leaseback transaction, an asset is sold by a vendor and then the same asset is leased back to the same vendor. The lease payment and sale price are normally interdependent because they are negotiated as part of the same package.
The accounting treatment depends on whether the transfer of the asset is sale, determined by reference to SFRS(I) 15.

### 5.1 Transfer is not a sale

If the transfer is not a sale in line with SFRS(I) 15, it is in substance a loan and is recognised as a financing transaction:

<table>
<thead>
<tr>
<th>Vendor (lessee)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Continues to recognise the asset in the statement of financial position</td>
</tr>
<tr>
<td></td>
<td>Recognises a financial liability in line with SFRS(I) 9</td>
</tr>
<tr>
<td></td>
<td>DEBIT Bank</td>
</tr>
<tr>
<td></td>
<td>CREDIT Financial liability</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Purchaser (lessor)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Does not recognise the asset in the statement of financial position</td>
</tr>
<tr>
<td></td>
<td>Recognises a financial asset in line with SFRS(I) 9</td>
</tr>
<tr>
<td></td>
<td>DEBIT Financial asset</td>
</tr>
<tr>
<td></td>
<td>CREDIT Bank</td>
</tr>
</tbody>
</table>

### 5.2 Transfer is a sale

If the transfer qualifies as a sale in line with SFRS(I) 15, the sale is recognised as follows:

<table>
<thead>
<tr>
<th>Vendor (lessee)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Derecognises the underlying asset in the statement of financial position</td>
</tr>
<tr>
<td></td>
<td>Recognises a right-of-use asset in respect of the rights to the asset that are retained</td>
</tr>
<tr>
<td></td>
<td>Recognises a lease liability</td>
</tr>
<tr>
<td></td>
<td>Recognises a gain or loss on transfer of the rights to the asset that are not retained.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Purchaser (lessor)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Recognises the purchase of an asset in line with the relevant standard</td>
</tr>
<tr>
<td></td>
<td>Applies SFRS(I) 16 lessor accounting (section 4).</td>
</tr>
</tbody>
</table>

The treatment applied by the vendor/lessee is best seen by way of an example.

### Example

Barlow Wholesale Ltd (BWL) sells a packaging machine for its fair value of $300,000 to Frost Solutions Ltd (FSL) on 1 August 20X7. On this date the machine had a carrying amount of $260,000. On the same date BWL entered into an arrangement to lease back the machine for 6 years in an arrangement determined by FSL to be an operating lease. Annual lease payments are $35,000 in arrears and the implicit interest rate is 7%. The present value of the lease payments at 1 August 20X7 is $178,507. The transfer qualifies as a sale.

Explain how BWL and FSL should account for the transfer.

### Solution

**BWL**

Both the carrying amount of the machine ($260,000) and the profit on transfer of $40,000 ($300,000 – $260,000) must be split into the portion that relates to the retained rights and the portion that relates to the transferred rights.

This split is based on fair values; the fair value of the machine in its entirety is $300,000; the fair value of the retained right-of-use asset is $178,507 (the lease liability).
Therefore:

<table>
<thead>
<tr>
<th></th>
<th>Retained</th>
<th>Transferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying asset</td>
<td>$260,000</td>
<td>$260,000 – $154,706</td>
</tr>
<tr>
<td></td>
<td>$260,000 x 178,507/300,000</td>
<td>= $154,706</td>
</tr>
<tr>
<td></td>
<td>$260,000 – $154,706</td>
<td>$105,294</td>
</tr>
<tr>
<td>Gain</td>
<td>$40,000</td>
<td>$40,000 – $23,801</td>
</tr>
<tr>
<td></td>
<td>$40,000 x 178,507/300,000</td>
<td>= $23,801</td>
</tr>
<tr>
<td></td>
<td>$40,000 – $23,801</td>
<td>= $16,199</td>
</tr>
</tbody>
</table>

In respect of the retained rights ($):

**DEBIT** Right-of-use asset 154,706
**CREDIT** Underlying asset (PPE) 154,706
to recognise the transfer of part of the underlying asset to be a right-of-use asset

In respect of the transferred rights ($):

**DEBIT** Bank 300,000
**CREDIT** Underlying asset (PPE) 105,294
**CREDIT** Lease liability 178,507
**CREDIT** Gain on transfer 16,199
to derecognise the transferred rights and recognise the related gain, proceeds and the lease liability

**FSL**

FSL should recognise the machine at cost of $300,000 by ($):

**DEBIT** Machine 300,000
**CREDIT** Bank 300,000

This is an operating lease arrangement and therefore FSL recognise income in each year of the lease of $35,000.

### 5.2.1 Non-market terms

In a transfer that is a sale, adjustment must be made for any non-market terms eg where the fair value of consideration for the transfer is not equal to the fair value of the underlying asset.

Any below market terms are accounted for as a prepayment of lease payments; any above market terms are accounted for as additional financing provided by the lessor to the lessee.

### SECTION SUMMARY

The accounting treatment of a sale and leaseback transaction depends on whether the transfer qualifies as a sale in line with SFRS(I) 15. Where it does, a sale is recognised and lessee/lessor accounting is subsequently applied. Where it does not, the transaction is in substance a financing transaction and SFRS(I) 9 is applied.
6 Disclosure

SECTION INTRODUCTION

SFRS(I) 16 provides the disclosure requirements in respect of lease arrangements for both lessees and lessors.

The objective of lessee and lessor disclosures is to provide information that gives users a basis to assess the effect that leases have on the financial statements.

6.1 Lessee disclosures

The following should be disclosed for the reporting period:

(a) Depreciation charge for right-of-use assets by class of underlying asset
(b) Interest expense on lease liabilities
(c) The expense in relation to leases accounted for using simplified accounting
(d) The expense relating to variable lease payments not included in measurement of the lease liability
(e) Income from subleasing right-of-use assets
(f) Additions to right-of-use assets
(g) Gains or losses on sale and leaseback transactions
(h) The carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset
(i) Total cash outflow for leases

Other required disclosures include:

(a) The amount of lease commitments for short-term leases accounted for using simplified accounting if dissimilar to amounts in the reporting year
(b) SFRS(I) 1-40 disclosures in respect of right-of-use assets that meet the definition of investment property.
(c) SFRS(I) 1-16 disclosures if right-of-use assets are measured using the SFRS(I) 1-16 revaluation model
(d) A maturity analysis of lease liabilities in line with SFRS(I) 7 separately from the maturity analysis of other financial liabilities
(e) A statement that simplified accounting is applied, if relevant.

Additional information may be required in order to meet the overall objective of disclosures on leases. This may include:

- The nature of the lessee's leasing activities
- Potential exposure to future cash flows that are not reflected in the measurement of lease liabilities
- Restrictions or covenants imposed by leases
- Sale and leaseback transactions

6.2 Lessor disclosures

A lessor should disclose the following for a reporting period, usually in a tabular format:

(a) Finance leases: selling profit or loss, finance income on the net investment in the lease and income relating to variable lease payments.
(b) Operating leases: lease income
Additional information may be required in order to meet the overall objective of disclosures on leases. This may include:

- The nature of the lessor's leasing activities
- How the lessor manages risk associated with rights retained in underlying assets

### 6.2.1 Operating leases

A lessor should apply the disclosure requirements of SFRS(I) 1-16, SFRS(I) 1-36, SFRS(I) 1-38, SFRS(I) 1-40 and SFRS(I) 1-41.

A maturity analysis of lease payments should also be provided, showing undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.

### 6.2.2 Finance leases

A lessor should provide a qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in finance leases.

A maturity analysis of lease payments receivable should be provided, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. These amounts should be reconciled to the net investment in the lease.

---

**SECTION SUMMARY**

Lessees and lessors must disclose information that gives users a basis to assess the effect of leases on the financial statements.
Chapter Roundup

SFRS(I) 16 Leases

Lease contract

- Right to control
- Identified asset
- For period of time

Lessee accounting

- Lessee accounting model
- Right of use asset and lease liability
  - Asset is depreciated
  - Liability is amortised
- Simplified accounting
- Short term and low value leases
  - Expense on straight-line basis over term
- Operating lease
- Retain asset in SOFP
  - Income on straight-line basis over term
- Finance lease
- Derecognise underlying asset
- Recognise net investment in lease
- Recognise sale and subsequent lease
- Apply SFRS(I) 9 – financing transaction

Lessor accounting

- Operating lease
- Finance lease
- Transfer is a sale (SFRS(I) 15)
- Transfer not a sale (SFRS(I) 15)

Sale and leaseback

- Recognise sale and subsequent lease
- Apply SFRS(I) 9 – financing transaction

Disclosures
Quick Quiz

1. Distinguish between a finance lease and an operating lease.
2. How is a lease liability measured?
3. A lease contract may convey the right to use more than one underlying asset. When are these separated as individual lease components within the contract?
4. When may a lessee apply simplified accounting?
5. How is a sale and leaseback transaction in which the transfer is not a sale accounted for?
6. How does a lessor account for an operating lease?
Answers to Quick Quiz

1. (a) A finance lease transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not be transferred eventually to the lessee.
   (b) An operating lease is a lease in which substantially all of the risks and rewards of ownership are not transferred to the lessee.

2. The present value of future lease payments discounted to present value using the interest rate implicit in the lease (or the lessee’s incremental borrowing rate).

3. The right to use an underlying asset is a separate lease component if:
   (a) The lessee can benefit from the underlying asset either on its own or together with other resources that are readily available to the lessee (including goods or services that are sold or leased separately), and
   (b) The underlying asset is not highly dependent on or interrelated with the other underlying assets in the contract.

4. When a lease is for a low value underlying asset or when a lease is for a term of 12 months or less at commencement date.

5. As a financing transaction in line with SFRS(I) 9.

6. Lease income is recognised in profit or loss on a straight line basis over the lease term (or another systematic basis if more representative of the pattern of benefit from the lease).

Answers to Questions

11.1 Lease contract

A contract is a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

<table>
<thead>
<tr>
<th>Truckitt</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Right to control</strong></td>
<td>GCL has the right to direct the use of the delivery truck for the contract term and no other party can use it during this time. Therefore, although Truckitt will operate and maintain the vehicle, GCL will obtain substantially all economic benefits from it.</td>
<td></td>
</tr>
<tr>
<td><strong>Identified asset</strong></td>
<td>The contract relates to an identified truck.</td>
<td></td>
</tr>
<tr>
<td><strong>Period of time</strong></td>
<td>Specified in the contract at 24 months.</td>
<td></td>
</tr>
<tr>
<td><strong>Conclusion</strong></td>
<td>The contract is a lease arrangement.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>VHL</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Right to control</strong></td>
<td>The issue is whether GCL has the right to control the vehicle given the mileage restriction on usage. SFRS(I) 16 states that when assessing control, only the economic benefits that are available within the defined scope of the customer's right to use an asset should be considered. Within the constraints of the maximum mileage, GCL may use the vehicle as it wishes and therefore the company has the right to control the vehicle.</td>
<td></td>
</tr>
<tr>
<td><strong>Identified asset</strong></td>
<td>The contract relates to a specified vehicle.</td>
<td></td>
</tr>
<tr>
<td><strong>Period of time</strong></td>
<td>Specified in the contract at three years</td>
<td></td>
</tr>
<tr>
<td><strong>Conclusion</strong></td>
<td>The contract is a lease arrangement.</td>
<td></td>
</tr>
</tbody>
</table>
11.2 Simplified accounting

This lease is not for a low value asset; it is however a short-term lease.

A lease term is the non-cancellable period for which a lessee has the right to use the underlying asset, plus:

(a) Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise the option; and

(b) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise the option.

The non-cancellable period is the initial 12 months of the lease. The remaining 12 months are covered by an option to terminate the lease. These form part of the lease term only if SDL is reasonably certain not to exercise the option. This is not the case and therefore the additional 12 months are not part of the lease term. The lease is for 12 months and is therefore short-term.

SDL may elect to apply simplified accounting to this class of assets and assuming that it does, an expense of $19,333 in recognised in profit or loss for the year ended 31 October 20X7:

Total cost is $5,000 + (12 × $2,000) = $29,000
Therefore for 8 months: $29,000 × 8/12m = $19,333

11.3 Lease liability

The lease liability is initially measured at the present value of the future lease payments discounted at the lessee's incremental borrowing rate.

This lease includes fixed payments in advance of $50,000 and variable payments in arrears based on output. Variable payments are included in the calculation of the lease liability only if they are based on a rate or index or if they are in substance fixed. In this case there is an in-substance fixed payment of $10,000 per annum, being the minimum additional payment.

Therefore the lease liability is initially measured at:

<table>
<thead>
<tr>
<th></th>
<th>Fixed payment $</th>
<th>In-substance fixed payment $</th>
<th>Total $</th>
<th>Discount factor</th>
<th>Present value $</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 June 20X6</td>
<td>50,000</td>
<td>–</td>
<td>50,000</td>
<td>1/1.04</td>
<td>50,000</td>
</tr>
<tr>
<td>1 June 20X7</td>
<td>50,000</td>
<td>10,000</td>
<td>60,000</td>
<td>1/1.04²</td>
<td>57,692</td>
</tr>
<tr>
<td>1 June 20X8</td>
<td>50,000</td>
<td>10,000</td>
<td>60,000</td>
<td>1/1.04³</td>
<td>55,473</td>
</tr>
<tr>
<td>1 June 20X9</td>
<td>50,000</td>
<td>10,000</td>
<td>60,000</td>
<td>1/1.04⁴</td>
<td>53,340</td>
</tr>
<tr>
<td>1 June 20Y0</td>
<td>50,000</td>
<td>10,000</td>
<td>60,000</td>
<td>1/1.04⁵</td>
<td>51,288</td>
</tr>
<tr>
<td>31 May 20Y1</td>
<td>–</td>
<td>10,000</td>
<td>10,000</td>
<td>1/1.04⁶</td>
<td>8,219</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>276,012</td>
</tr>
</tbody>
</table>

The additional expected variable payment of $1,000 per annum ((1,100 × $10) – $10,000) will be expensed when incurred.
11.4 Right-of-use asset

The right-of-use asset is initially measured at:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial measurement of lease liability (11.3)</td>
<td>276,012</td>
</tr>
<tr>
<td>Lease payments made by lessee before commencement of lease</td>
<td>5,000</td>
</tr>
<tr>
<td>Initial direct costs incurred by the lessee</td>
<td>3,000</td>
</tr>
<tr>
<td>Estimated dismantling and restoration costs at the end of</td>
<td>46,000</td>
</tr>
<tr>
<td>the lease term</td>
<td></td>
</tr>
<tr>
<td>(payable by the lessee)</td>
<td></td>
</tr>
<tr>
<td>Cost of right-of-use asset</td>
<td>330,012</td>
</tr>
</tbody>
</table>

This is recognised by ($):

DEBIT Right-of-use asset 330,012
CREDIT Lease liability 276,012
CREDIT Bank 8,000
CREDIT Provision for dismantling 46,000

11.5 Lessee accounting model

The lease liability is initially measured at:

<table>
<thead>
<tr>
<th>Payment</th>
<th>Discount factor</th>
<th>Present value</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 June 20X7</td>
<td>7,000</td>
<td>6,601</td>
</tr>
<tr>
<td>30 June 20X8</td>
<td>7,000</td>
<td>6,230</td>
</tr>
<tr>
<td>30 June 20X9</td>
<td>7,000</td>
<td>5,880</td>
</tr>
<tr>
<td>30 June 20Y0</td>
<td>7,000</td>
<td>5,544</td>
</tr>
<tr>
<td>30 June 20Y1</td>
<td>7,000</td>
<td>5,229</td>
</tr>
</tbody>
</table>

The variable payments are not part of the measurement of the lease liability as they are not fixed in substance and are not related to a rate or index.

The lease liability is amortised as follows:

<table>
<thead>
<tr>
<th>B/f</th>
<th>Interest at 6%</th>
<th>Payment</th>
<th>C/f</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>30 June 20X7</td>
<td>29,484</td>
<td>1,769</td>
<td>(7,000)</td>
</tr>
<tr>
<td>30 June 20X8</td>
<td>24,253</td>
<td>1,455</td>
<td>(7,000)</td>
</tr>
</tbody>
</table>

The right-of-use asset is initially measured at:

| $000 |
| Initial measurement of lease liability (see above) | 29,484 |
| Arrangement fee                                     | 4,000 |

This is depreciated over the five year lease term, giving an annual depreciation charge of $6,697 (33,484/5).

Journal entries (all in $)

At 1 July 20X6 (not required; shown for illustration)

DEBIT Right-of-use asset 33,484
CREDIT Lease liability 29,484
CREDIT Bank 4,000

to recognise the right-of-use asset and lease liability at the commencement of the lease
Year ended 30 June 20X7

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense</td>
<td>Right-of-use asset</td>
<td>6,697</td>
</tr>
<tr>
<td>Finance cost</td>
<td>Lease liability</td>
<td>1,769</td>
</tr>
<tr>
<td>Lease liability</td>
<td>Bank</td>
<td>7,000</td>
</tr>
<tr>
<td>Variable lease payment</td>
<td>Bank</td>
<td>1,000</td>
</tr>
</tbody>
</table>

Financial statements

Statement of financial position at 30 June 20X7

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset (33,484 – 6,697)</td>
<td>26,787</td>
</tr>
<tr>
<td>Lease liability – non current</td>
<td>18,708</td>
</tr>
<tr>
<td>Lease liability – current (7,000 – 1,455)</td>
<td>5,545</td>
</tr>
</tbody>
</table>

Statement of profit or loss for year ended 30 June 20X7

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>6,697</td>
</tr>
<tr>
<td>Finance cost</td>
<td>1,769</td>
</tr>
</tbody>
</table>
SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets was covered in your undergraduate studies. This chapter recaps the requirements of the standard and introduces some common scenarios and the relevant accounting treatment. Accounting for uncertainty requires professional judgment and you must consider the available evidence and circumstances carefully in order to apply the appropriate accounting treatment.
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measurement and Reporting (liabilities)</strong>&lt;br&gt;Apply, explain and evaluate accounting standards for major classes of liabilities insofar as they affect initial recognition, measurement (including initial measurement and subsequent re-measurement), classification and disclosure and de-recognition from an entity's statement of financial position.</td>
<td>3</td>
</tr>
<tr>
<td><strong>Specific Applications</strong>&lt;br&gt;Apply the relevant accounting treatment on the following classes of liabilities: provisions and contingencies.</td>
<td>3</td>
</tr>
<tr>
<td><strong>Emerging Trends</strong>&lt;br&gt;Demonstrate awareness of both domestic and international current developments.</td>
<td>1</td>
</tr>
</tbody>
</table>

**ESSENTIAL READING**

SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets,<br>SFRS(I) INT 6 Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment, SFRS(I) INT 21 Levies

1 Introduction

**SECTION INTRODUCTION**

Guidance on accounting for provisions and contingencies is provided by SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets. The treatment of provisions and contingencies must be consistent in order that the financial statements convey an entity's financial position reliably. This area of accounting does, however, require the extensive application of professional judgment.

Financial statements must include all of the information necessary for an understanding of the company's financial position. Provisions, contingent liabilities and contingent assets are 'uncertainties' that must be accounted for consistently if we are to achieve this understanding.

1.1 The historical problem

Before SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets, there was no accounting standard dealing with provisions or accounting for uncertain outcomes. Many companies therefore took advantage of this lack of regulation in order to manipulate and smooth profits. Those wanting to show their results in the most favourable light used to make large 'one off' general provisions in years where a high level of underlying profits was generated. These provisions, often known as 'big bath' provisions, were then released to profit in future years when perhaps the underlying profits were not as good.

Profit smoothing such as this can mislead the users of financial statements, whilst the existence of provisions without reason in the statement of financial position results in an understatement of net assets.
1.2 Objective of SFRS(I) 1-37

**IMPORTANT**

The key aim of SFRS(I) 1-37 is therefore to ensure that provisions are made only where there are valid grounds for them. In order to achieve fair presentation and avoid misuse of profit smoothing, it is crucial that the requirements of the standard are adhered to.

SFRS(I) 1-37 aims to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

1.3 Use of judgment

Although SFRS(I) 1-37 goes a long way to achieving uniformity in accounting for uncertain outcomes, in particular by providing recognition criteria and measurement rules for provisions, it remains that this is a grey area of financial reporting in which extensive professional judgment must be applied.

Throughout this chapter we refer to the use of professional judgment in assessing outcomes and values. When applying judgment, the objective of management should be to neither understate nor overstate provisions. A degree of prudence is necessary, however, such that excessive provisions are not made.

Although recognising and measuring provisions is the responsibility of a company's management, they will be influenced by available evidence and, where relevant, expert opinion. For example, a Chartered Accountant is not in the best position to assess the probable outcome of a legal case. A lawyer could, however, provide an informed opinion, and it is on this that the accounting treatment is based.

The IASB and Singapore ASC appreciate that provisions and contingency accounting is a judgmental area, and for this reason, an appendix of illustrative examples is provided alongside SFRS(I) 1-37. The appendix takes common scenarios and applies the requirements of the standard in order to reach a conclusion as to whether a provision is required. These illustrative examples should be read and applied in the same way as the main standard, and only deviated from in rare cases.

1.4 Scope of SFRS(I) 1-37

The standard applies to all entities in accounting for provisions, contingent liabilities and contingent assets except:

- Those arising from executory contracts, where the contract is not onerous
- Financial instruments (including guarantees) that are within the scope of SFRS(I) 9

**SECTION SUMMARY**

SFRS(I) 1-37 addresses the historical problem of manipulating the financial statements through 'big bath provisions' by putting in place recognition criteria and measurement rules for provisions. It remains that this is one area of accounting where there is an extensive need for the application of professional judgment, however evidence and expert opinion should be used where possible.
2 Provisions

SECTION INTRODUCTION

A provision is recognised only when SFRS(I) 1-37 recognition criteria are met; it is measured in accordance with the standard at the best estimate of the expenditure required to settle the obligation.

2.1 Definitions

SFRS(I) 1-37 provides definitions as follows.

**KEY TERMS**

A **PROVISION** is a liability of uncertain timing or amount.

A **LIABILITY** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

(SFRS(I) 1-37)

The standard distinguishes provisions from other liabilities such as trade payables and accruals. This is on the basis that for a provision there is uncertainty about the timing or amount of the future expenditure. While uncertainty is clearly present in the case of certain accruals the uncertainty is generally less compared to that present when a provision is recognised.

A provision is recognised as a liability in the statement of financial position, and normally a corresponding expense is recognised in the statement of profit or loss as follows:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense</td>
<td>Provision</td>
</tr>
<tr>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

In some circumstances, however, the recognition of a provision relates to the creation of an asset. An example of this is decommissioning costs, which are discussed further in section 2.6.8.

2.2 Recognition

SFRS(I) 1-37 states that a provision should be recognised as a liability in the financial statements when all of the following criteria are met.

**KEY POINT**

a. An entity has a **present obligation** (legal or constructive) as a result of a past event.

b. It is probable that a **transfer of economic benefits** will be required to settle the obligation.

c. A **reliable estimate** can be made of the obligation.

Each of these recognition criteria is considered in further detail below.
2.2.1 Present obligation as result of past event

A present obligation as a result of a past event is an obligation which exists at the reporting date as a result of an event which has already occurred. The requirement for the obligation to be the result of a past event means that provisions cannot be made to reflect the future intentions of an entity.

SFRS(I) 1-37 states that the obligation may be either legal or constructive. A legal obligation is an obligation that derives from:

- A contract;
- Legislation; or
- Other operation of the law.

Where legislation is proposed, but not yet finalised, an obligation arises only when the legislation is virtually certain to be enacted as drafted; SFRS(I) 1-37 states that it is almost impossible to be virtually certain that draft legislation will be enacted until it actually is.

Example

During the period ended 31 March 20X3, a company sells a tablet computer with a one year warranty. On 20 March the customer informed the company that the tablet would no longer power up.

At 31 March 20X3, the company has a present legal obligation (to mend the tablet under the warranty agreement) and this obligation is the result of a past event (the sale of the tablet).

A constructive obligation is defined as:

An obligation that derives from an entity's actions where:

(a) By an established pattern of past practice, published policies or a sufficiently specific current statement the entity has indicated to other parties that it will accept certain responsibilities; and

(b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Some constructive obligations will be obvious, for example, many retailers have a policy of giving cash refunds to dissatisfied customers whether or not the goods that they bought are faulty. Such a policy might be over and above any legal obligation, but a constructive obligation arises from the retailer's established or published practice. Clearly, the essence of a constructive obligation is the entity's commitment to a third party. That commitment arises through the entity's actions (that is, by establishing a pattern of practice or by publishing its policies or by making a statement setting out in detail its intended future actions).

Question 12.1

Recognise a provision

In which of the following circumstances is there a present constructive obligation at 31 December 20X9?

(a) On 13 December 20X9 the board of an entity decided to close down a division. The end of the reporting period of the company is 31 December. Before 31 December 20X9 the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

(b) The board agreed a detailed closure plan on 20 December 20X9 and details were given to customers and employees.

(c) A company is not legally obliged to incur clean up costs for environmental damage (that has already been caused), however the company advertises itself as 'ultra-environmentally conscious: one of the greenest companies in Singapore'.

(d) A company intends to carry out future expenditure to operate in a particular way in the future.
In some rare cases, it is not clear whether a past event has given rise to a present obligation. For example, in the case of a lawsuit, it may be disputed whether certain events have occurred and whether those events result in a present obligation. Where this is the case, management must consider whether it is more likely than not that a present obligation as a result of a past event exists. In order to assess this, they must consider all available evidence and, if relevant, the opinion of experts in order to assess whether there is a present obligation as a result of a past event.

2.2.2 Probable transfer of economic benefits

For the purpose of SFRS(I) 1-37, an outflow of resources embodying economic benefits is regarded as ‘probable’ if the event is more likely than not to occur ie the probability that it will occur is greater than the probability that it will not. This appears to indicate a probability of more than 50%. However, the standard makes it clear that where there are a number of similar obligations the probability should be based on considering the population as a whole, rather than one single item.

Note SFRS(I) 1-37 makes it clear that this interpretation of ‘probable’ as ‘more likely than not’ does not necessarily apply in other standards.

Example

If a company has entered into a warranty obligation then the probability of an outflow of resources embodying economic benefits may well be extremely small in respect of one specific item. However, when considering the population as a whole the probability of some transfer of economic benefits is quite likely to be much higher. If there is a greater than 50% probability of some transfer of economic benefits then a provision should be made for the expected amount.

2.2.3 Reliable estimate

The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. SFRS(I) 1-37 states that in all but extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

In very rare cases where a reliable estimate cannot be made, the liability which is not recognised must be disclosed as a contingent liability (see section 3).
### 2.2.4 Decision tree

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is there a present legal obligation as a result of a past event?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is there a present constructive obligation as a result of a past event?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is an outflow of economic resources probable?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Can the outflow be reliably measured?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Recognise a provision</td>
<td>Do not recognise a provision</td>
<td>Consider whether a contingent liability should be disclosed (see section 3)</td>
</tr>
</tbody>
</table>

### 2.2.5 SFRS(I) INT 6 Liabilities Arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment

SFRS(I) INT 6 *Liabilities Arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment* provides guidance on the recognition of liabilities for waste management under the European Union (EU) Directive in respect of sales of historical household equipment. This may be relevant for Singapore companies with subsidiaries in the EU. The EU Directive regulates the collection, treatment, recovery and disposal of waste equipment. It states that the cost of waste management of historical household equipment should be borne by the producers of this type of equipment who are in the market during the measurement period (the measurement period would be specified by legislation in each Member State). In accordance with the Directive, producers should contribute to costs in proportion to their respective share of the market. Historical waste relates to products sold before 13 August 2005.

The key issue which SFRS(I) INT 6 deals with is what constitutes an obligating event in accordance with SFRS(I) 1-37 (Paragraph 14(a)) in this context. It considers three possibilities:

1. The manufacture or sale of the historical household equipment
2. Participation in the market during the measurement period
3. The incurrence of costs in the performance of waste management activities

The consensus reached by SFRS(I) INT 6 is that participation in the market during the measurement period is the obligating event. As a result a liability does not arise as the products are manufactured or sold. No obligation arises until a market share exists during the measurement period.

### 2.2.6 SFRS(I) INT 21 Levies

SFRS(I) INT 21 provides guidance on when to recognise a liability for a levy imposed by a government. A levy is an outflow of resources embodying economic benefits that is imposed on entities by governments in accordance with legislation. SFRS(I) INT 21 does not apply to amounts within the scope of other standards (eg taxes) or fines or penalties for the breach of legislation.

A government-imposed levy may result in a provision or, where the timing and amount are certain, a liability that is not a provision.
The obligating event for the recognition of a liability is the activity that triggers the payment of the levy in accordance with relevant legislation.

A liability for a levy is recognised progressively if the obligating event occurs over a period of time; if it is triggered when a minimum threshold is reached, then the liability is recognised when that threshold is reached.

### 2.3 Measurement of provisions

**KEY POINT**

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

The estimates will be determined by the judgment of the entity’s management supplemented by the experience of similar transactions, and in some cases, reports from independent experts.

There are a number of different techniques that can be used to arrive at the best estimate required to settle an obligation. Generally, entities will base their estimate on:

(a) Single most likely outcome
(b) Weighted average of all possible outcomes ie expected value method

#### 2.3.1 Single obligation

Where a single obligation is being measured, the single most likely outcome may be the best estimate of the expenditure required to settle the obligation. Note that the expected value method can be applied to a single obligation with various possible outcomes.

#### 2.3.2 Large population of items

Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities, ie expected value.

### Question 12.2

**Warranty**

C Co sells goods with a warranty under which customers are covered for the total cost of repairs of any manufacturing defect that becomes apparent within the first six months of purchase. The company’s past experience and future expectations indicate the following pattern of likely repairs.

<table>
<thead>
<tr>
<th>Probability</th>
<th>Defects</th>
<th>Total cost of repairs</th>
</tr>
</thead>
<tbody>
<tr>
<td>75%</td>
<td>None</td>
<td>–</td>
</tr>
<tr>
<td>20%</td>
<td>Minor</td>
<td>1.0</td>
</tr>
<tr>
<td>5%</td>
<td>Major</td>
<td>4.0</td>
</tr>
</tbody>
</table>

What is the expected cost of repairs?

#### 2.3.3 Risks and uncertainties

Risks and uncertainties should be taken into account when considering the best estimate of a provision and these may result in adjustment to the measurement of a provision. It is, however, important to adhere to the basic concepts that:
(a) Liabilities must not be understated in the financial statements, but
(b) Uncertainty does not justify the excessive use of provisions or a deliberate overstatement of liabilities.

2.3.4 Present value

Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditure required to settle the obligation.

The discount rate should be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. Note that the estimation of a risk-adjusted discount rate requires judgment and it may be preferable to instead include the impact of risk when estimating cash flows and apply to these a risk-free rate. Whichever approach is used, care should be taken to avoid double counting or omitting the effect of any risks.

The yield on a government bond with an AAA credit rating is generally viewed as a risk-free pre-tax rate.

The discount is subsequently unwound over the period until the expenditure arises by:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Finance costs</th>
<th>X</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Provision</td>
<td>X</td>
</tr>
</tbody>
</table>

to unwind the discount in relation to the provision and recognise the unwinding as a finance cost in the statement of profit or loss

Example

On 1 April 20X1, the management of Woodlands Furniture Pte Ltd assess that a provision is required in respect of future decontamination costs at its factory site. The costs are expected to amount to $2 million and will be incurred in five years' time on 31 March 20X6. An appropriate pre-tax discount rate is 5%.

The provision is initially recognised on 1 April 20X1 at $1,567,052 (2m \times 1/1.05^5) ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Decontamination costs</th>
<th>1,567,052</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Provision for decontamination costs</td>
<td>1,567,052</td>
</tr>
</tbody>
</table>

Amounts are then recognised in the financial statements over the five years until the costs are incurred as follows.

<table>
<thead>
<tr>
<th>Period ended</th>
<th>Interest cost</th>
<th>Journal</th>
<th>Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 March</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>20X2</td>
<td>1,567,052 \times 5%</td>
<td>DEBIT Finance cost 78,353</td>
<td>1,645,405</td>
</tr>
<tr>
<td></td>
<td>= 78,353</td>
<td>CREDIT Provision 78,353</td>
<td></td>
</tr>
<tr>
<td>20X3</td>
<td>1,645,405 \times 5%</td>
<td>DEBIT Finance cost 82,270</td>
<td>1,727,675</td>
</tr>
<tr>
<td></td>
<td>= 82,270</td>
<td>CREDIT Provision 82,270</td>
<td></td>
</tr>
<tr>
<td>20X4</td>
<td>1,727,675 \times 5%</td>
<td>DEBIT Finance cost 86,384</td>
<td>1,814,059</td>
</tr>
<tr>
<td></td>
<td>= 86,384</td>
<td>CREDIT Provision 86,384</td>
<td></td>
</tr>
<tr>
<td>20X5</td>
<td>1,814,059 \times 5%</td>
<td>DEBIT Finance cost 90,703</td>
<td>1,904,762</td>
</tr>
<tr>
<td></td>
<td>= 90,703</td>
<td>CREDIT Provision 90,703</td>
<td></td>
</tr>
<tr>
<td>20X6</td>
<td>1,904,762 \times 5%</td>
<td>DEBIT Finance cost 95,238</td>
<td>2,000,000</td>
</tr>
<tr>
<td></td>
<td>= 95,238</td>
<td>CREDIT Provision 95,238</td>
<td></td>
</tr>
</tbody>
</table>

The provision is therefore equal to the costs incurred at the payment date, and the payment is recorded by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Provision</th>
<th>2,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Cash</td>
<td>2,000,000</td>
</tr>
</tbody>
</table>
An exact formula has been used to calculate the present value. A different value will be derived if PV tables are used.

### 2.3.5 Future events

Future events which are reasonably expected to occur may affect the amount required to settle the entity's obligation and should be taken into account when measuring a provision.

Gains from the expected disposal of assets should not be taken into account in measuring a provision.

**Example**

An oil exploration company is legally required to clean up a drill site when it has concluded operations at the site in ten years' time. The provision for cleaning up the site is measured at an amount which reflects future expected cost reductions associated with an additional ten years' experience in applying existing clean-up technology as assessed by technically qualified, objective observers. Measurement of the provision will not, however, anticipate the development of a completely new technology unless supported by sufficient objective evidence.

### 2.3.6 Summary of measurement rules

<table>
<thead>
<tr>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>SINGLE OBLIGATION</td>
</tr>
<tr>
<td>Single most likely outcome or use expected value method</td>
</tr>
<tr>
<td>LARGE POPULATION</td>
</tr>
<tr>
<td>Use expected values (outcomes × probability)</td>
</tr>
<tr>
<td>CONSIDER</td>
</tr>
<tr>
<td>RISKS and UNCERTAINTIES</td>
</tr>
<tr>
<td>May result in adjustment to provision</td>
</tr>
<tr>
<td>DISCOUNTING</td>
</tr>
<tr>
<td>Discount if effect of time value of money material</td>
</tr>
<tr>
<td>Use pre-tax rate eg yield on government bond with AAA rating</td>
</tr>
<tr>
<td>FUTURE EVENTS</td>
</tr>
<tr>
<td>Take into account if reasonably expected to occur</td>
</tr>
<tr>
<td>Not gain on future disposal of assets</td>
</tr>
</tbody>
</table>

SFRS(I) 1-37 para 48
SFRS(I) 1-37 para 51
Example

Biotech Ltd (BL), a Singapore based company, operates from a number of locations throughout south east Asia and has a functional currency of Singapore dollars. One of its offices is located in Kuala Lumpur, and new legislation in Malaysia enacted on 30 September 20X2 requires that carbon dioxide detectors are fitted or retro fitted into all office spaces. As at the end of the reporting period, 31 December 20X2, BL had not fitted the detectors. The detectors will cost 100,000 Malaysian Ringgit (MYR) to fit, and continued failure to do so will result in a fine of between MYR150,000 and MYR250,000 at the discretion of the Malaysian authorities. The authorities aim to spot check all offices and since the legislation was enacted, they have visited 75% offices (excluding BL) and levied fines on all of those that were non-compliant. To date 90% fines levied have been successfully collected. In all cases to date the minimum amount of MYR150,000 has been levied.

Relevant exchange rates are:

<table>
<thead>
<tr>
<th>Date</th>
<th>$1: MYR</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 September 20X2</td>
<td>2.3</td>
</tr>
<tr>
<td>31 December 20X2</td>
<td>2.5</td>
</tr>
</tbody>
</table>

What provision, if any, should Biotech Ltd make in its accounts at 31 December 20X2?

Solution

| Present obligation as the result of a past event? | There is no present obligation to fit the carbon dioxide detectors since no obligating event has occurred (being the fitting of the detectors). An obligation may, however, arise to pay a fine. Here the fact that BL has operated its Kuala Lumpur office without complying with the law to fit carbon dioxide detectors is the obligating event. |
| Probable outflow? | Assessment of the probability of incurring a fine depends on the stringency of the enforcement regime. The authorities intend to spot check all offices and have already checked 75%, levying a fine on all of those which are not compliant. A high majority of those fined have paid the required amount to the authorities. The probability of the authorities collecting a fine is therefore high, and it is unlikely that the estimated obligation should be reduced to reflect the uncertainty surrounding a spot check occurring or a fine being pursued. |
| Reliable estimate? | Non-compliance results in a fine of between MYR150,000 and MYR250,000. Based on the experience of other companies, the most likely outcome is a fine of MYR 150,000. |
| Conclusion | A provision should be made in BL’s accounts as follows. At 30 September 20X2, set up provision ($):

DEBIT Expense (MYR150,000/2.3) 65,217
CREDIT Provision for fines and penalties 65,217

At 31 December 20X2, re-measure the provision to $60,000 (MYR150,000/2.5) at the end of the reporting period using the exchange rate at that date ($):

DEBIT Provision for fines and penalties 5,217
CREDIT Exchange gain 5,217 |
2.4 Reimbursements

Some or all of the expenditure needed to settle a provision may be expected to be recovered from a third party. If so, the reimbursement should be recognised only when it is virtually certain that reimbursement will be received if the entity settles the obligation.

(a) The reimbursement should be treated as a separate asset, and the amount recognised should not be greater than the provision itself.

(b) The provision and the amount recognised for reimbursement may be netted off when presented in the statement of comprehensive income.

2.5 Changes in provisions

A provision which has been recognised in the statement of financial position will change in the following circumstances:

(a) If the provision is used
(b) If the amount of the provision is re-assessed
(c) To reflect changes in exchange rates

2.5.1 Use of provisions

A provision should be used only for expenditures for which the provision was originally recognised. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Where a provision is used:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Provision</th>
<th>X</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Cash</td>
<td>X</td>
</tr>
</tbody>
</table>

2.5.2 Reassessment of provision

Provisions should be reviewed at each period end and adjusted to reflect the current best estimate. This includes re-assessment of both discount rate (where relevant) and cash flows. If it is no longer probable that a transfer of economic benefits will be required to settle the obligation, the provision should be reversed and released to profit:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Provision</th>
<th>X</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Expense</td>
<td>X</td>
</tr>
</tbody>
</table>

to release a provision which is no longer required back to profit or loss

2.5.3 Changes in exchange rates

Where a provision relates to an amount payable in a foreign currency, it is important to remember that this is a monetary liability and must therefore be retranslated at the reporting date with any gain or loss recognised in profit or loss in accordance with SFRS(I) 1-21 or SFRS(I) 9 if hedge accounting has been used.

Example

Orchard Park Ltd made a provision of $182,000 in its 20X1 period-end financial statements in respect of a present obligation of £100,000 and an exchange rate of $1:£0.55. The provision related to a legal claim for unfair dismissal brought by an employee in one of Orchard Park Ltd's overseas offices. At the 20X2 period end, the legal case has not been settled and is reassessed based on current evidence at £120,000. The period end exchange rate is $1:£0.52.
What amounts are recognised in the 20X2 financial statements in respect of the provision?

**Solution**

**Statement of financial position**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provision (120,000/0.52)</td>
<td>230,769</td>
</tr>
</tbody>
</table>

**Statement of profit or loss and other comprehensive income**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange loss (182,000 – (100,000/0.52))</td>
<td>10,308</td>
</tr>
<tr>
<td>Increase in provision (20,000/0.52)</td>
<td>38,461</td>
</tr>
</tbody>
</table>

**2.6 Common scenarios**

The following scenarios are common and therefore are addressed within SFRS(I) 1-37, either within the text of the standard itself or within the illustrative examples which accompany the standard.

**2.6.1 Future operating losses**

Provisions should not be recognised for future operating losses. They do not meet the definition of a liability and the general recognition criteria set out in the standard.

**2.6.2 Onerous contracts**

**KEY TERM**

An Onerous Contract is a contract entered into with another party under which the unavoidable costs of fulfilling the terms of the contract exceed any revenues expected to be received from the goods or services supplied or purchased directly or indirectly under the contract. The unavoidable costs under the contract reflect the least net cost of exiting from the contract and is the lower of the cost of fulfilling it and any compensation or penalties arising from the failure to fulfil it.

Another contractual idiom relevant to applying SFRS(I) 1-37 is 'executory' contracts. An executory contract is a contract under which neither party has performed any of its obligations, or both parties have only partially performed their obligations to an equal extent. Upon complete performance by all parties, a contract is said to be fully executed. Executory contracts can be either non-onerous or onerous. A non-onerous contract is one where all costs are avoidable or the unavoidable costs of not fulfilling the contract or exiting from it are less than the economic benefits expected to be received if the contract is fully executed. By contrast, an onerous contract is one where the unavoidable costs of fulfilling the contract or exiting from it exceed the economic benefits expected to be received. While executory contracts are outside the scope of SFRS(I) 1-37, if the contract is onerous or becomes onerous, SFRS(I) 1-37 applies.

If an entity has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision. An example is a 12 month lease contract to obtain use of a property; if the lessee has no further use for the property part way through the lease, however cannot cancel the agreement or sublet the property, the contract becomes onerous. In this case the obligation is the future lease payments.
A lease agreement that becomes onerous is within the scope of SFRS(I) 1-37 and results in the creation of a provision only if SFRS(I) 16 simplified accounting is applied to the lease or if the lease has not yet commenced. In other situations SFRS(I) 16 requires that a lease liability is recognised and therefore no provision is required to reflect amounts that the lessee has an obligation to pay.

2.6.3 Provisions for restructuring

Where an entity restructuring its operations, there are inevitable costs involved. In certain circumstances, some of these costs may be provided for. Before considering those circumstances and the relevant costs, we shall consider what is meant by ‘restructuring’.

**KEY TERM**

SFRS(I) 1-37 defines a **Restructuring** as:

A programme that is planned and controlled by management, and materially changes either:

- The scope of a business undertaken by an entity; or
- The manner in which that business is conducted.

SFRS(I) 1-37 gives the following **examples** of events that may fall under the definition of restructuring.

(a) The sale or termination of a line of business
(b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another
(c) Changes in management structure, for example, the elimination of a layer of management
(d) Fundamental reorganisations that have a material effect on the nature and focus of the entity’s operations

The question is whether or not an entity has a **present obligation** at the end of the reporting period in respect of restructuring costs. SFRS(I) 1-37 states that a constructive obligation arises only when an entity:

- Has a **detailed formal plan** for the restructuring, and
- Has **raised a valid expectation** in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

**IMPORTANT**

* A mere management decision to restructure operations is not normally sufficient, unless this decision has been formalised in a plan and public or employee announcements made.

Where the restructuring involves the **sale of an operation** then SFRS(I) 1-37 states that no obligation arises until the entity has entered into a **binding sale agreement**. This is because until this has occurred the entity will be able to change its mind and withdraw from the sale even if its intentions have been announced publicly.

SFRS(I) 1-37 states that a restructuring provision should include only the **direct expenditures** arising from the restructuring.

- **Necessarily entailed** by the restructuring
- Not associated with the **ongoing activities** of the entity
The following costs should specifically **not** be included within a restructuring provision.

- **Retraining** or relocating continuing staff
- **Marketing**
- **Investment in new systems** and distribution networks

The following decision tree summarises the issues when dealing with a provision for restructuring:

1. **Is there a restructuring as defined by SFRS(I) 1-37?**
   - A programme planned and controlled by management that materially changes the scope of business or manner in which it is conducted.
   - **Yes**
     - **Does the restructuring involve the sale of an operation?**
       - **Yes**
         - **Is there a binding sale agreement?**
           - **Yes**
             - **Has the plan been announced or its implementation begun?**
               - **Yes**
                 - **No provision is made**
               - **No**
                 - **No provision is made**
             - **No**
               - **No provision is made**
           - **No**
             - **No provision is made**
       - **No**
         - **No provision is made**
   - **No**
     - **No provision is made**

2.6.4 **Warranties**

Where a manufacturer or retailer provides a standard warranty for the repair costs of an item sold, should it break down or defects become apparent within a set period, a provision can be made for the expected future repair costs.

In this case the provision of a standard warranty is contractual hence this is a legal present obligation, with the past event being the sale of the item in question. A transfer of resources is considered probable as on past experience it is likely that some claims will emerge. Where there are a number of similar obligations the provision must be estimated on the basis of the class as a whole using expected values.

**Example**

Star Electrics Ltd normally sells 3D televisions at a price of $2,500 each, including a one year warranty to cover defects. On 31 December 20X4 the company held an end of year promotion, offering the televisions at $1,900 each. On this date it sold 200 televisions, providing them to customers immediately; it expects 10 of these to show defects within the 12 month warranty period.
Past experience reveals that on average the cost of repairing defects is $400. The company's year end is 31 December.

How are the sale and the warranty accounted for at 31 December 20X4?

**Solution**

Revenue earned is $380,000 ($1,900 \times 200). This is recognised immediately on 31 December 20X4 in accordance with SFRS(I) 15 Revenue from Contracts with Customers since control of the televisions passes to customers immediately ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Revenue</td>
</tr>
<tr>
<td>380,000</td>
<td>380,000</td>
</tr>
</tbody>
</table>

On this date a provision is also recognised for the expected warranty costs of $4,000 ($400 \times 10) ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty expense</td>
<td>Warranty provision</td>
</tr>
<tr>
<td>4,000</td>
<td>4,000</td>
</tr>
</tbody>
</table>

The example above deals with a standard warranty, being a warranty effective immediately after the sale and provided as part of a sale agreement, sometimes on a statutory basis. A company may also offer its customers an extended warranty which covers a period of time after the standard warranty has expired.

An extended warranty is normally provided to a customer at an additional cost, although it may be provided free of charge (see Chapter 17). As a result the accounting treatment is focused on the recognition of revenue associated with the warranty provision; costs incurred as a result of the extended warranty are recognised as they arise.

The provision of extended warranties equates to a separate performance obligation in line with SFRS(I) 15 and the related transaction price is recognised over time. Therefore the revenue received at the point of sale that is associated with an extended warranty is deferred and released to profit or loss over the warranty coverage period, in the same pattern as the expected costs.

**Example**

Assume the same example as that above, however, this time Star Electrics Ltd offers an extended warranty to customers priced at an additional of $300. On 31 December 20X4 all 200 customers purchase the extended warranty, which provides cover against defects for the two years immediately after the standard warranty expires. Past experience has shown that 15 televisions will show defects in the first year of the extended warranty and 30 televisions in the second year of the extended warranty. As expected, 10 televisions require repair under the standard warranty in year one (at a total cost of $4,600) and 15 televisions require repair under the extended warranty in year two (at a total cost of $6,000). In year three 25 televisions require repair at a total cost of $10,500.

How are the sale and the standard and extended warranties accounted for?

**Solution**

At 31 December 20X4 the company is paid $380,000 (as before) in respect of the television sets provided and $60,000 ($300 \times 200) in respect of the extended warranties ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Revenue</td>
</tr>
<tr>
<td>440,000</td>
<td>380,000</td>
</tr>
<tr>
<td>Deferred warranty income</td>
<td>60,000</td>
</tr>
</tbody>
</table>
On this date a provision is also recognised for the expected standard warranty costs of $4,000 ($400 × 10) ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty expense</td>
<td>Warranty provision</td>
</tr>
<tr>
<td>4,000</td>
<td>4,000</td>
</tr>
</tbody>
</table>

During the year ended 31 December 20X5, 10 television sets are repaired under the standard warranty ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty provision</td>
<td></td>
</tr>
<tr>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Profit or loss</td>
<td></td>
</tr>
<tr>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4,600</td>
</tr>
</tbody>
</table>

In the year ended 31 December 20X6, part of the deferred warranty income is released and recognised as revenue. The amount released is based on the extended warranty costs arising in the year as a proportion of the total expected extended warranty costs:

Extended warranty costs arising in the year are $6,000 ($400 × 15) and total expected extended warranty costs are $18,000 ($400 × 45). Therefore $20,000 (6/18 × $60,000) revenue is recognised ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred warranty income</td>
<td>Revenue</td>
</tr>
<tr>
<td>20,000</td>
<td>20,000</td>
</tr>
</tbody>
</table>

The costs of meeting the warranty claims are recognised by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty expense</td>
<td></td>
</tr>
<tr>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>6,000</td>
</tr>
</tbody>
</table>

In the year ended 31 December 20X7, the remainder of the deferred warranty income is released and recognised as revenue ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred warranty income</td>
<td>Revenue</td>
</tr>
<tr>
<td>40,000</td>
<td>40,000</td>
</tr>
</tbody>
</table>

The costs of meeting the warranty claims are recognised by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty expense</td>
<td></td>
</tr>
<tr>
<td>10,500</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10,500</td>
</tr>
</tbody>
</table>

### 2.6.5 Major overhauls

Prior to SFRS(I) 1-37, it was common for companies to gradually accrue a provision for expenditure on major asset overhauls over the intervening years between overhauls. Under SFRS(I) 1-37 this is not possible, as there is not a present obligation to carry out an overhaul, simply an intention (even when the entity knows it must undertake the overhaul in the future if the asset is to remain legally operational); a company could sell an asset before such an overhaul was carried out.

The only solution is to treat major assets such as aircraft, ships, furnaces and so on as a series of smaller assets where each part is depreciated over shorter lives. Thus, any major overhaul may be argued to be replacement and therefore capital rather than revenue expenditure (see SFRS(I) 1-16 for guidance).

### 2.6.6 Self-insurance

Companies sometimes wish to create a provision for self-insurance based on the expected cost of making good any fire damage and so on instead of paying premiums to an insurance company. Under SFRS(I) 1-37 such a provision is not justifiable as there is no present obligation until a fire or accident occurs.
2.6.7 Environmental contamination

Where a company contaminates land, that company has a present obligation to clean up the contamination where:

(a) There is legislation in place which requires it to do so; or
(b) The company has an environment policy such that other parties would expect the company to clean up any contamination (a constructive obligation).

Although the above requirements follow the letter of the standard (law), other issues may arise as a result of strict application of these requirements. For instance, failure to clean up may negatively affect the entity's ability to remain a going concern if it fails its duty of care in terms of environmental responsibilities as expected by the community. That is, community pressure may force the company to clean up or go out of business.

2.6.8 Decommissioning, restoration or abandonment costs

A company may operate from a certain location on a temporary basis and on abandoning that location in the future it will be legally required to decommission (remove) its operations and put right the location. This scenario is common to the oil industry: when an oil company initially purchases an oilfield it is put under a legal obligation to decommission the site at the end of its life.

In this situation, SFRS(I) 1-37 states that the legal obligation to decommission the site exists as soon as the initial expenditure on the oilfield arises, and therefore a provision should be made at this time. The standard takes the view that the cost of purchasing the oilfield in the first place is not only the cost of the field itself, but also the costs of putting it right again. Thus decommissioning should be capitalised rather than expensed to profit or loss when the provision is made:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current asset</td>
<td>Decommissioning provision</td>
</tr>
<tr>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

To recognise a decommissioning cost as part of the cost of a non-current asset and as a provision.

As decommissioning is likely to take place a number of years after the oilfield is purchased, the time value of money is likely to be relevant and therefore the amount provided for is capitalised and discounted.

The same principle applies to the restoration of assets, particularly leased assets. If the lessee is contractually obliged to return a leased asset to the lessor in its original condition at the end of a lease term, a restoration provision must be recognised if the underlying asset's condition changes or is changed at any point in the lease term. The provision is recognised as part of the right-of-use asset in accordance with SFRS(I) 16 (see Chapter 11).

Example

T Co is involved in mining precious metals, an activity which causes significant damage to the environment, in particular deforestation. The company completed the setting up of a mine in Australia on 1 February 20X2, and it is required, when it decommissions the mine in ten years' time, to rectify any environmental damage that it has caused. The costs of abandonment (including environmental restoration) will be AUS$5,000,000. A pre-tax discount rate of 3% has been established. T Co's period end date is 31 January.

Relevant exchange rates are:

<table>
<thead>
<tr>
<th>Date</th>
<th>Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 February 20X2</td>
<td>$1: AUS$0.75</td>
</tr>
<tr>
<td>31 January 20X3</td>
<td>$1: AUS$0.80</td>
</tr>
</tbody>
</table>

Average for y/e 31 January 20X3: $1: AUS$0.78

(a) How are the abandonment costs accounted for when the mine is set up?
(b) What amount is reported in respect of the abandonment provision at 31 January 20X3?
Solution

(a) When the mine is set up the abandonment costs are capitalised as part of the cost of the mine and provided for.

(i) AUS$5,000,000 is discounted to AUS$3,720,469 (5,000,000/1.03^{10})

(ii) AUS$3,720,469 is translated to $4,960,625 (3,720,469/0.75)

The abandonment costs are accounted for at 1 February 20X2 by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Cost of mine</th>
<th>4,960,625</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Abandonment provision</td>
<td>4,960,625</td>
</tr>
</tbody>
</table>

To recognise the costs of abandonment as part of the cost of the mine and as a provision.

(b) At 31 January 20X3 the discount must be unwound and the provision retranslated:

AUS$3,720,469 \times 1.03 = AUS$3,832,083

AUS$3,832,083/0.8 = $4,790,104

The provision is reported at $4,790,104 in the financial statements at 31 January 20X3. The provision has decreased (when you would expect it to increase due to the unwinding of the discount) as a result of the strengthening of the Singapore dollar against the Australian dollar.

The decrease in provision is recognised by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Finance cost (W1)</th>
<th>143,095</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Provision</td>
<td>170,521</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Exchange gain (SPL) (W2)</td>
<td>313,616</td>
</tr>
</tbody>
</table>

(W1) The finance cost is 3\% \times AUS$3,720,469 = AUS$111,614. This is translated at the average rate to give AUS$111,614/0.78 = $143,095

(W2) The exchange gain is made up of two elements – the retranslation of the opening balance of the provision to closing rate and the retranslation of the finance cost to closing rate:

<table>
<thead>
<tr>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance (AUS$3,720,469)</td>
<td>4,960,625</td>
</tr>
<tr>
<td>At opening rate of 0.75</td>
<td>4,960,625</td>
</tr>
<tr>
<td>At closing rate of 0.8</td>
<td>4,650,586</td>
</tr>
<tr>
<td>Total exchange gain</td>
<td>310,039</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance cost (AUS$111,614)</td>
<td>143,095</td>
</tr>
<tr>
<td>At average rate of 0.78</td>
<td>143,095</td>
</tr>
<tr>
<td>At closing rate of 0.8</td>
<td>139,518</td>
</tr>
<tr>
<td>Total exchange gain</td>
<td>3,577</td>
</tr>
</tbody>
</table>

2.6.9 SFRS(I) INT 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities

SFRS(I) INT 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities deals with changes in the measurement of existing decommissioning, restoration and other similar liabilities that have been both recognised as:

- Part of the cost of an item of property, plant and equipment (in accordance with SFRS(I) 1-16) or part of the cost of a right-of-use asset in accordance with SFRS(I) 16; and
- A liability in accordance with SFRS(I) 1-37.
These changes arise due to the following (SFRS(I) INT 1 Paragraph 3).

(a) A change in the estimated outflow of resources embodying economic benefits required to settle the obligation;

(b) A change in the current market-based discount rate as defined in Paragraph 47 of SFRS(I) 1-37; and

(c) An increase that reflects the passage of time (i.e., the unwinding of the discount).

In the case of (c), the unwinding of the discount is recognised in profit or loss and does not affect the carrying amount of the asset.

In the case of (a) and (b), the treatment required depends on whether the related asset is measured using the cost model or the revaluation model. The following diagram summarises the accounting treatment, however you should refer to SFRS(I) INT 1 for further details. You should also review SFRS(I) INT 1 Illustrative Examples.

### Diagram:

- **Asset**
  - Measured using cost model
    - Change in liability added or deducted from cost (SFRS(I) INT 1 Paragraph 5(a))
    - Amount deducted must not exceed carrying amount – excess recognised in profit or loss immediately (SFRS(I) INT 1 Paragraph 5(b))
  - Measured using revaluation model
    - Recognise **decrease** in liability in other comprehensive income and increase revaluation surplus (to the extent that it reverses a revaluation deficit recognised in profit or loss) (SFRS(I) INT 1 Paragraph 6(a)(i))
    - If decrease in liability exceeds cost model carrying amount recognise excess in profit or loss immediately (SFRS(I) INT 1 Paragraph 6(b))
    - Recognise **increase** in liability in profit or loss (recognise in other comprehensive income to the extent of any credit balance in the revaluation surplus) (SFRS(I) INT 1 Paragraph 6(a)(ii))

---

**2.7 SFRS(I) 1-37 Disclosure requirements**

Disclosures for provisions fall into two parts:

- Disclosure of details of the **change in carrying amount** of a provision from the beginning to the end of the reporting period
- Disclosure of the **background** to the making of the provision and the uncertainties affecting its outcome, together with any expected reimbursement
Sometimes, entities are jointly and severally liable for an obligation. Joint and several obligations often arise in joint venture arrangements where two or more parties co-operate to build, develop or exploit a particular product. Where joint and several obligations arise, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. A provision is recognised in respect of the part of the obligation that will be met by the entity itself except in the very rare circumstances when no reliable estimate can be made.

Example

The following example is taken from Singapore Airlines Annual Report 2016/2017.

19 Provisions (in $million)

Included are provisions for return costs for leased aircraft, onerous leases, lease end liability, warranty claims and upgrade costs. It is expected that the return costs will be incurred by the end of the lease terms.

An analysis of the provisions is as follows:

The Group

<table>
<thead>
<tr>
<th>Return costs for leased aircraft</th>
<th>Onerous leases</th>
<th>Others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 1 April 2016</td>
<td>1,002.5</td>
<td>41.9</td>
<td>51.2</td>
</tr>
<tr>
<td>Provision during the year</td>
<td>286.4</td>
<td>2.6</td>
<td>26.6</td>
</tr>
<tr>
<td>Provision written back during the year</td>
<td>(8.0)</td>
<td>–</td>
<td>(0.2)</td>
</tr>
<tr>
<td>Provision utilised during the year</td>
<td>(151.2)</td>
<td>(13.3)</td>
<td>(13.3)</td>
</tr>
<tr>
<td>Reclassification</td>
<td>7.5</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Balance at 31 March 2017</td>
<td>1,137.2</td>
<td>31.2</td>
<td>64.3</td>
</tr>
<tr>
<td>Current</td>
<td>296.7</td>
<td>13.7</td>
<td>12.0</td>
</tr>
<tr>
<td>Non-current</td>
<td>840.5</td>
<td>17.5</td>
<td>52.3</td>
</tr>
<tr>
<td>Balance at 1 April 2017</td>
<td>1,137.2</td>
<td>31.2</td>
<td>64.3</td>
</tr>
<tr>
<td>Provision during the year</td>
<td>270.5</td>
<td>0.5</td>
<td>23.9</td>
</tr>
<tr>
<td>Provision written back during the year</td>
<td>(11.5)</td>
<td>(0.7)</td>
<td>–</td>
</tr>
<tr>
<td>Provision utilised during the year</td>
<td>(295.4)</td>
<td>(14.5)</td>
<td>(14.9)</td>
</tr>
<tr>
<td>Balance at 31 March 2018</td>
<td>1,100.8</td>
<td>16.5</td>
<td>73.3</td>
</tr>
<tr>
<td>Current</td>
<td>348.4</td>
<td>6.8</td>
<td>13.9</td>
</tr>
<tr>
<td>Non-current</td>
<td>752.4</td>
<td>9.7</td>
<td>59.4</td>
</tr>
<tr>
<td>Balance at 1 April 2017</td>
<td>1,100.8</td>
<td>16.5</td>
<td>73.3</td>
</tr>
</tbody>
</table>


2.7.1 Non-disclosure

SFRS(I) 1-37 permits reporting entities to avoid disclosure requirements relating to provisions (and contingent liabilities and contingent assets) if they would be expected to seriously prejudice the position of the entity in dispute with other parties. However, this should only be employed in extremely rare cases. Details of the general nature of the provision/contingencies must still be provided, together with an explanation of why it has not been disclosed.
Example

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of $10 million. The information usually required by SFRS(I) 1-37 is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company.

SECTION SUMMARY

- A provision is recognised where it meets all three SFRS(I) 1-37 recognition criteria:
  1. An entity has a legal or constructive present obligation as a result of a past event.
  2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
  3. A reliable estimate can be made of the amount of the obligation.

- A provision is measured at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period; the provision should be discounted where the time value of money is significant.

- A provision may not be made in respect of future operating losses, major overhauls or self-insurance.

- A provision may be made in respect of onerous contracts, standard warranties, environmental contamination and decommissioning costs, provided that the recognition criteria are met.

- A provision may be made in respect of certain restructuring costs where a detailed formal plan for the restructuring exists (or a binding sale agreement in the case of a sale) and the plan has been announced to those affected by it.

3 Contingent liabilities

SECTION INTRODUCTION

An entity should not recognise a contingent liability, but they should be disclosed.
### 3.1 Definition

**KEY TERM**

SFRS(I) 1-37 defines a **Contingent Liability** as:

- A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- A present obligation that arises from past events but is not recognised because:
  - It is not probable that a transfer of economic benefits will be required to settle the obligation; or
  - The amount of the obligation cannot be measured with sufficient reliability.

A contingent liability is therefore an uncertain future expenditure which does not meet one of more of the three SFRS(I) 1-37 recognition criteria:

- There is no present obligation, rather a possible obligation.
- A transfer of economic resources is possible rather than probable.
- The obligation cannot be measured reliably.

We have already said that probable means more than 50% likely. Therefore, ‘possible’ is less than or equal to 50%. At the 50% level additional professional judgment would be required.

### 3.2 Treatment of contingent liabilities

Contingent liabilities should **not be recognised in financial statements** but they should be disclosed unless the possibility of an outflow of economic resources is remote. The required disclosures are:

- A brief description of the nature of the contingent liability
- An estimate of its financial effect
- An indication of the uncertainties that exist
- The possibility of any reimbursement

If it is not practicable to disclose this information, then that fact should be stated.

**Example**

During the reporting period, a customer of C Ltd instigated proceedings against it for alleged defects in industrial machinery which, it is claimed were the cause of a major fire in the customer's premises. Total losses to the customer have been estimated at $1 million and this amount is being claimed from the Company.

The Company's legal advisers have said that they do not consider that the suit has merit and they have recommended that it be contested. No provision has been made in these financial statements as the Company's management do not consider that there is any probable outflow of economic benefits.
Example

The following contingent liability disclosure is taken from the Fraser and Neave Limited and Subsidiary Companies Annual Report 2017:

CONTINGENT LIABILITIES

The Company issued corporate guarantees to the extent of $2,780,000,000 (2016: $2,460,978,000) for the purpose of assisting its subsidiary companies to obtain external borrowings. Of the $2,780,000,000 (2016: $2,460,978,000) corporate guarantees given by the Company, $820,000,000 (2016: $Nil) has been utilised by its subsidiary companies as security for its borrowings.


SECTION SUMMARY

A contingent liability is either a possible obligation or a present obligation which does not meet the SFRS(I) 1-37 recognition criteria. Where an outflow of resources is not remote, a contingent liability should be disclosed in the financial statements.

4 Contingent assets

SECTION INTRODUCTION

An entity should not recognise a contingent asset; a contingent asset is disclosed in the financial statements when the inflow of economic benefits is probable.

4.1 Definition

KEY TERM

SFRS(I) 1-37 defines a CONTINGENT ASSET as:

- A possible asset that arises from past events and whose existence will be confirmed by the occurrence of one or more uncertain future events not wholly within the entity's control.

SFRS(I) 1-37 provides an example of a contingent asset as a claim that an entity is pursuing through legal processes where the outcome is uncertain.

4.2 Treatment of contingent assets

A contingent asset must not be recognised. Only when the realisation of the related economic benefits is virtually certain should recognition take place. At that point, the asset is no longer a contingent asset.
Contingent assets must only be disclosed in the notes if they are **probable**. In that case a brief description of the contingent asset should be provided along with an estimate of its likely financial effect. SFRS(I) 1-37 emphasises the importance of ensuring that disclosure of contingent assets does not mislead the reader as to the likelihood of income being received.

If it is not practicable to disclose the required information, then that fact should be stated.

**SECTION SUMMARY**

Contingent assets are possible assets. Where an inflow of economic resources is probable, they are disclosed (but not recognised) in the financial statements.

**SECTION INTRODUCTION**

You must practise the questions below to get the hang of SFRS(I) 1-37. But first, study the flow chart, taken from SFRS(I) 1-37, which is a good summary of its requirements.

**IMPORTANT**

This flow chart demonstrates the thought process that can be used to help you to answer exam questions dealing with an outflow of economic benefits.
Selat Trading Co gives warranties at the time of sale to purchasers of its products. Under the terms of the warranty the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within a period of three years from the year-end.

Required

Should a provision be recognised?
Question 12.4

After a wedding in 20X8 ten people died, possibly as a result of food poisoning from products sold by Stanley Catering Co (SCC). Legal proceedings have started seeking damages from SCC, but SCC disputes liability. Up to the date of approval of the financial statements for the period to 31 December 20X8, SCC’s lawyers advise that it is probable that SCC will not be found liable. However, when SCC prepares the financial statements for the period to 31 December 20X9 its lawyers advise that, owing to developments in the case, it is probable that SCC will be found liable.

Required

What is the required accounting treatment and disclosure:

(a) At 31 December 20X8?
(b) At 31 December 20X9?

SECTION SUMMARY

The decision tree provided in the Implementation Guidance which accompanies SFRS(I) 1-37 will help in the application of the standard to practical scenarios.
Chapter Roundup

**SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets**

Provisions
- Liability of uncertain timing or amount
- Recognise where all criteria are met:
  1. A legal or constructive obligation exists as a result of a past event
  2. There is a probable outflow of economic benefits
  3. A reliable estimate can be made of the outflow
- Disclose unless outflow of resources is remote

Contingent liabilities
- Possible obligation or present obligation that does not meet recognition criteria for provision
- Disclose where inflow of resources is probable

Contingent assets
- Possible asset arising from past events
- Disclose where inflow of resources is probable

1. A legal or constructive obligation exists as a result of a past event
2. There is a probable outflow of economic benefits
3. A reliable estimate can be made of the outflow

Legal: arising from a contract, legislation or other operation of law.
Constructive: entity has created an expectation that it will accept and discharge responsibilities

I.e an outflow is more likely than not to occur

- Single obligation: best estimate
- Large population: expected values
- Adjust provision for risks and uncertainties
- Discount if time value of money material
- Take into account future events expected to occur.
Quick Quiz

1. According to SFRS(I) 1-37 when, and only when, can a provision be recognised?
2. How should a provision for a standard washing machine warranty be measured?
3. When should provisions be discounted and at what discount rate?
4. A provision can be made for future operating losses. True or false?
5. When should a contingent liability be recognised?
Answers to Quick Quiz

1. There must be:
   - A present obligation as a result of a past event
   - A probable transfer of economic benefits
   - A reliable estimate of value

2. As we are probably dealing with a large population of items, expected values should be used.

3. A provision should be discounted when the time value of money is 'significant'. A pre-tax risk-free discount rate should be used.

4. False

5. Never. However, they should be disclosed in a note to the accounts if a transfer of economic resources is not remote.

Answers to Questions

12.1 Recognise a provision

(a) There is no constructive obligation as the decision has not been communicated.

(b) The announcement of the closure plan to other parties creates a constructive obligation.

(c) The company has created a constructive obligation by promoting itself as environmentally friendly. This creates an expectation on the part of other parties that it will accept the responsibility of the clean-up and associated costs.

(d) There is no present obligation, legal or constructive. This is because the entity could avoid the intended future expenditure.

12.2 Warranty

The cost is found using 'expected values' (75% × $nil) + (20% × $1.0m) + (5% × $4.0m) = $400,000.

12.3 Recognise or not? 1

Selat Trading cannot avoid the cost of repairing or replacing all items of product that manifest manufacturing defects in respect of which warranties are given before the end of the reporting period, and a provision for the cost of this should therefore be made.

Selat Trading is obliged to repair or replace items that fail within the entire warranty period. Therefore, in respect of this year's sales, the obligation provided for at the period end should be the cost of making good items for which defects have been notified but not yet processed, plus an estimate of costs in respect of the other items sold for which there is sufficient evidence that manufacturing defects will manifest themselves during their remaining periods of warranty cover.

12.4 Recognise or not? 2

(a) At 31 December 20X8

On the basis of the evidence available when the financial statements were approved, there is probable outflow of economic benefit. No provision is recognised. The matter is disclosed as a contingent liability unless the probability of an outflow of economic benefit is regarded as remote.

Disclosure should be made of the estimated financial effect, and uncertainties relating to the amount or timing of the outflow.
(b) At 31 December 20X9

On the basis of the evidence available, there is a present obligation. An outflow of economic benefits in settlement is now probable.

A provision is recognised for the best estimate of the amount needed to settle the present obligation.

The following disclosures should be made in respect of the provision for damages:

- A reconciliation of opening carrying amount (nil) to closing carrying amount which details the provision made in the period.
- A brief description of the nature of the provision and expected timing of outflows of economic benefits, together with an indication of the uncertainties about the amount or timing of those outflows.
In almost all countries entities are taxed on the basis of their trading income and in Singapore corporate income tax is applied to taxable profits.

There are two aspects of income tax which must be accounted for: **current tax** and **deferred tax**. Current tax is revised briefly in Section 1. The rest of this chapter is concerned with deferred tax, which users invariably find difficult.

### Topic list

1. Current tax
2. Deferred tax
3. Taxable temporary differences
4. Deductible temporary differences
5. Measurement and recognition of deferred tax
6. Deferred taxation and business combinations
7. Disclosures
8. Related interpretations
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measurement and Reporting (liabilities)</td>
<td>3</td>
</tr>
<tr>
<td>Apply, explain and evaluate accounting standards for major classes of liabilities insofar as they affect initial recognition, measurement (including initial measurement and subsequent re-measurement), classification and disclosure and de-recognition from an entity's statement of financial position. Generally, while liabilities are more common in the context of SFRS(I) 1-12, assets also arise in some circumstances and these are covered in the materials as well.</td>
<td></td>
</tr>
<tr>
<td>Specific Applications</td>
<td>3</td>
</tr>
<tr>
<td>Apply the relevant accounting treatment on the following classes of liabilities: income tax.</td>
<td></td>
</tr>
<tr>
<td>Emerging Trends</td>
<td>1</td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments.</td>
<td></td>
</tr>
</tbody>
</table>

ESSENTIAL READING

SFRS(I) 1-12 Income taxes, SFRS(I) 1-12 Illustrative Examples, SFRS(I) INT 1-25 Changes in the Tax Status of an Entity or its Shareholders.

1 Current tax

SECTION INTRODUCTION

Current tax is the amount payable to the tax authorities in relation to the taxable profit during the period. It is generally a straightforward calculation with various adjustments being made to accounting profit to derive taxable profit.

Current tax is ordinarily straightforward. Complexities arise, however, when we consider the future tax consequences of what is going on in the accounts now. This is an aspect of tax called deferred tax, which we will look at in the next section. SFRS(I) 1-12 Income Taxes covers both current and deferred tax. The parts relating to current tax are fairly brief, because this is the simple and uncontroversial area of tax.

SFRS(I) 1-12 Income Taxes must be read in conjunction with the Income Tax Act and associated regulations, schedules and Inland Revenue Authority of Singapore (IRAS) pronouncements.
1.1 Definitions

These are some of the definitions given in SFRS(I) 1-12. We will look at the rest later.

**KEY TERMS**

- **Accounting Profit**: Profit or loss for a period before deducting tax expense.
- **Taxable Profit (Tax Loss)**: The profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).
- **Tax Expense (Tax Income)**: The aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.
- **Current Tax**: The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Accounting profit and taxable profit are likely to be different for a number of reasons. For example, accounting profit will be after the deduction of depreciation of non-current assets. Taxable profit however, will include an adjustment for capital allowances. Certain items of income and expenditure which are accounted for in the financial statements on an accruals basis are accounted for tax purposes on a cash basis eg warranty costs.

Remember the difference between current and deferred tax.

(a) **Current tax** is the amount actually payable to the tax authorities in relation to the taxable profit of the entity during the period.

(b) **Deferred tax** is an accounting adjustment that estimates the amount of income taxes payable in future periods. It does not represent actual future tax payable to the tax authorities. Its purpose is to take into consideration the tax effects of transactions already accounted in the accounting books and hence, produce less distorted results.

1.2 Recognition of current tax liabilities and assets

SFRS(I) 1-12 requires any **unpaid tax** in respect of the current or prior periods to be recognised as a liability.

Conversely, any **excess tax** paid in respect of current or prior periods over what is due should be recognised as an asset.

**Question 13.1**

In 20X8 Jurong Lighting Pte Ltd had taxable profits of $120,000. In the previous year (20X7) income tax on 20X7 profits had been estimated as $15,000.

**Required**

Calculate tax payable and the charge for 20X8 if the tax rate is 8.5% and tax due on 20X7 profits was subsequently agreed with the tax authorities as:

(a) $17,000  
(b) $14,000

Any under- or over-payments are not settled until the following year's tax payment is due.
Taking this a stage further, SFRS(I) 1-12 also requires recognition as an asset of the benefit relating to any tax loss that can be **carried back** to recover current tax of a previous period. This is acceptable because it is probable that the benefit will flow to the entity and it can be reliably measured. Note that in Singapore certain conditions must be met in order to carry back tax losses.

### Example

In 20X7 Fragrant Flowers Pte Ltd paid $50,000 in tax on its profits. In 20X8 the company made tax losses of $24,000. The local tax authority rules allow losses to be carried back to offset against current tax of prior years. The relevant tax rate is 17%.

Show the tax charge and tax liability for 20X8.

### Solution

Tax repayment due on tax losses = 17% × $24,000 = $4,080

The double entry will be ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax receivable (statement of financial position)</td>
<td>4,080</td>
</tr>
<tr>
<td>Tax credit (statement of profit or loss and other comprehensive income)</td>
<td>4,080</td>
</tr>
</tbody>
</table>

The tax receivable will be shown as an asset until the repayment is received from the tax authorities.

1.3 Measurement

Measurement of current tax liabilities (assets) for the current and prior periods is simple once taxable income has been determined. They are measured at the **amount expected to be paid to (recovered from) the tax authorities**. The tax rates (and tax laws) used should be those enacted (or substantively enacted) by the year-end.

1.4 Recognition of current tax

Normally, current tax is recognised as income or an expense and included in the net profit or loss for the period, except in two cases.

(a) Tax arising from a **business combination** which is an acquisition is treated differently (see Section 6 of this chapter)

(b) Tax arising from a transaction or event which is recognised in other comprehensive income or **directly in equity** (in the same or a different period)

The rule in (b) is logical. If a transaction or event is charged or credited directly to equity, rather than to profit or loss, then the related tax should also be. An example of such a situation is where, under SFRS(I) 1-8, an adjustment is made to the **opening balance of retained earnings** due to either a change in accounting policy that is applied retrospectively, or to the correction of a material error.

1.5 Presentation

In the statement of financial position, **tax assets and liabilities** should be shown separately from other assets and liabilities.

Current tax assets and liabilities can be **offset**, but this should happen only when certain conditions apply.

(a) The entity has a **legally enforceable right** to set off the recognised amounts.

(b) The entity intends to settle the amounts on a **net basis**, or to realise the asset and settle the liability at the same time.
The tax expense (income) related to the profit or loss for the year should be shown in the profit or loss section of the statement of profit or loss and other comprehensive income.

**SECTION SUMMARY**

Current tax is measured at the amount expected to be paid to the tax authorities; it is normally recognised in profit or loss.

---

**2 Deferred tax**

**SECTION INTRODUCTION**

Deferred tax is an accounting adjustment that estimates the amount of income taxes payable or receivable in future periods. It is often found to be challenging when covered for the first time.

It is important that you read SFRS(I) 1-12 Illustrative Examples in conjunction with the standard itself.

**2.1 What is deferred tax?**

When a company recognises an asset or liability, it expects to recover or settle the carrying amount of that asset or liability. In other words, it expects to sell or use up assets, and to pay off liabilities. What happens if that recovery or settlement is likely to make future tax payments larger (or smaller) than they would otherwise have been if the recovery or settlement had no tax consequences? In these circumstances, SFRS(I) 1-12 requires companies to recognise a deferred tax liability (or deferred tax asset).

Note that deferred tax is not an amount currently payable to the tax authorities, nor is it relevant to tax practitioners; it is simply an accounting adjustment to more accurately portray the financial position and financial performance of the entity during the reporting period and embodies the matching principle. The below introductory example should help to make the application of its concept to a real example clearer. Following this example the more technical definitions will be covered. For now concentrate on what the example is illustrating.

**Example**

Woodlands Furniture Pte Ltd owns a machine that cost $1,000 two years ago and has a carrying amount of $800 (so being depreciated over ten years with no residual value). Capital allowances given to date are $667 (based on 33% per annum straight line) and the tax rate applicable to the company is 17%. The tax rates and allowances are not necessarily correct tax law at present but have been chosen to make the example relatively straightforward.

- To date (at the end of Year 2) Woodlands Furniture has claimed capital allowances and so received tax relief of $667.
- In the future the company will use the machine and recover the $800 carrying amount by generating at least that much in revenue.
- In the future the company will also be able to claim a further $333 in capital allowances in respect of the machine (i.e., the amount of the original cost which has not already been relieved). This is the tax base of the asset (definition in section 2.2 below).
- The net effect in the future of the $800 revenue to be generated and the $333 capital allowances to be generated is $467. This is a taxable temporary difference i.e., it is a profit which will be taxed in the future (definition in section 2.2 below).
The tax which will arise on this temporary difference (based on the 17% currently enacted tax rate) is $79.39.

Therefore Woodlands Furniture has a deferred tax liability of $79.39.

This can also be explained using the following table, assuming that the machine has a useful life of ten years but capital allowances are granted over three years. Note that at the end of the ten years the carrying amount of the asset is zero in the financial statements. It also has no tax written down value (TWDV) – this should help to explain why any difference between these two numbers is referred to as a temporary difference.

<table>
<thead>
<tr>
<th>Year</th>
<th>Current year</th>
<th>Cumulative</th>
<th>TW DV</th>
<th>Current year</th>
<th>Cumulative</th>
<th>Current year</th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>CY DT (exp)</td>
<td>CY DT</td>
<td>CR</td>
<td>BS DT Liab</td>
<td>BS DT Liab</td>
<td>BS DT Liab</td>
<td>BS DT Liab</td>
<td>BS DT Liab</td>
</tr>
<tr>
<td>Year 1</td>
<td>100</td>
<td>100</td>
<td>900</td>
<td>333</td>
<td>333</td>
<td>667</td>
<td>(233)</td>
</tr>
<tr>
<td>Year 2</td>
<td>100</td>
<td>200</td>
<td>800</td>
<td>334</td>
<td>667</td>
<td>333</td>
<td>(234)</td>
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<tr>
<td>Year 3</td>
<td>100</td>
<td>300</td>
<td>700</td>
<td>1,000</td>
<td>–</td>
<td>(233)</td>
<td>(700)</td>
</tr>
<tr>
<td>Year 4</td>
<td>100</td>
<td>400</td>
<td>600</td>
<td>–</td>
<td>1,000</td>
<td>–</td>
<td>100</td>
</tr>
<tr>
<td>Year 5</td>
<td>100</td>
<td>500</td>
<td>500</td>
<td>–</td>
<td>1,000</td>
<td>–</td>
<td>100</td>
</tr>
<tr>
<td>Year 6</td>
<td>100</td>
<td>600</td>
<td>400</td>
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<td>–</td>
<td>1,000</td>
<td>–</td>
<td>100</td>
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<tr>
<td>Year 8</td>
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<td>200</td>
<td>–</td>
<td>1,000</td>
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<td>100</td>
<td>–</td>
<td>1,000</td>
<td>–</td>
<td>100</td>
</tr>
<tr>
<td>Year 10</td>
<td>100</td>
<td>1,000</td>
<td>–</td>
<td>–</td>
<td>1,000</td>
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<td>100</td>
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</tbody>
</table>

2.2 Definitions

Here are the definitions relating to deferred tax given in SFRS(I) 1-12.

**KEY TERMS**

**Deferred tax liabilities** are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

**Deferred tax assets** are the amounts of income taxes recoverable in future periods in respect of:
- Deductible temporary differences
- The carryforward of unused tax losses
- The carryforward of unused tax credits

**Temporary differences** are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either:
- **Taxable temporary differences**, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.
- **Deductible temporary differences**, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

(SFRS(I) 1-12)
2.2.1 Tax base of an asset

We can expand on the definition given above by stating that the tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying amount of the asset. Where those economic benefits are not taxable, the tax base of the asset is the same as its carrying amount.

Question 13.2

State the tax base of each of the following assets.

(a) A machine cost $10,000. For tax purposes, depreciation of $3,000 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes.

(b) Interest receivable has a carrying amount of $1,000. The related interest revenue will be taxed on a cash basis.

(c) Trade receivables have a carrying amount of $10,000. The related revenue has already been included in taxable profit (tax loss).

(d) A loan receivable has a carrying amount of $1 million. The repayment of the loan will have no tax consequences.

(e) Dividends receivable from a subsidiary have a carrying amount of $5,000. The dividends are not taxable.

2.2.2 Tax base of a liability

In the case of a liability, the tax base will be its carrying amount, less any amount that will be deducted for tax purposes in relation to the liability in future periods. For revenue received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

Question 13.3

State the tax base of each of the following liabilities.

(a) Current liabilities include accrued expenses with a carrying amount of $1,000. The related expense will be deducted for tax purposes on a cash basis.

(b) Current liabilities include interest revenue received in advance, with a carrying amount of $10,000. The related interest revenue was taxed on a cash basis.

(c) Current liabilities include accrued expenses with a carrying amount of $2,000. The related expense has already been deducted for tax purposes.

(d) Current liabilities include accrued fines and penalties with a carrying amount of $100. Fines and penalties are not deductible for tax purposes.

(e) A loan payable has a carrying amount of $1 million. The repayment of the loan will have no tax consequences.
SFRS(I) 1-12 Illustrative Examples (IE) gives the following examples of circumstances in which the carrying amount of an asset or liability will be equal to its tax base.

- **Accrued expenses** have already been deducted in determining an entity's current tax liability for the current or earlier periods.
- A **loan payable** is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan.
- **Accrued expenses (eg fines and penalties)** will never be deductible for tax purposes.
- **Accrued income (eg capital gain on disposal)** will never be taxable.

### 2.2.3 Temporary differences

You may have found the definition of temporary differences somewhat confusing. Remember that accounting profits form the basis for computing **taxable profits**, on which the tax liability for the year is calculated. However, accounting profits and taxable profits are different. There are two reasons for the differences:

<table>
<thead>
<tr>
<th>Permanent differences</th>
<th>Temporary differences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occur when certain items of revenue or expense are excluded from the computation of taxable profits</td>
<td>Occur when items of revenue or expense are included in both accounting profits and taxable profits, but not for the same accounting period</td>
</tr>
<tr>
<td>Eg entertainment expenses may not be allowable for tax purposes</td>
<td>Eg an expense which is allowable as a deduction in arriving at taxable profits for 20X7 might not be included in the accounting profits until 20X8 or later</td>
</tr>
</tbody>
</table>

In the long run, the total taxable profits and total accounting profits will be the same (except for permanent differences) so that temporary differences originate in one period and are capable of reversal in one or more subsequent periods. Deferred tax is the tax attributable to temporary differences.

Taxable and deductible temporary differences are considered in more detail in the next two sections of this chapter.
2.3 Calculation of deferred tax

In order to calculate a deferred tax liability (or asset), the following approach should be taken.

| What is the carrying amount of the item? (Where the item is a liability this is a negative number) |
| What is the tax base of the item? |
| Is carrying amount greater than tax base? |
| Yes | The difference is a **taxable** temporary difference |
| No | The difference is a **deductible** temporary difference. |

\[
\text{X tax rate} \\
\text{Apply the tax rate to give a deferred tax asset} \\
\text{Apply the tax rate to give a deferred tax liability}
\]

Applying this approach to example 1:
- The carrying amount is $800
- The tax base is $333
- The taxable temporary difference is $467
- The deferred tax liability is $79.39

Applying this approach to question 13.3(a):
- The carrying amount is ($1,000)
- The tax base is nil
- The deductible temporary difference is $1,000
- The deferred tax asset is calculated as tax rate × $1,000

Each of these steps is considered in more detail throughout the chapter.
SECTION SUMMARY

Deferred tax is an accounting device. It does not represent tax payable to the tax authorities. It is calculated by:

1. Ascertaining carrying amount and tax base
2. Calculating a temporary difference between the two
3. Applying the tax rate

Where the temporary difference is taxable, the resulting figure is a deferred tax liability; where the temporary difference is deductible, the resulting figure is a deferred tax asset.

The tax base of an asset or liability is the value of that asset or liability for tax purposes. Deferred tax is the tax attributable to temporary differences.

3 Taxable temporary differences

SECTION INTRODUCTION

Deferred tax liabilities arise from taxable temporary differences.

As we have already seen, a taxable temporary difference arises where the carrying amount of an asset or liability is greater than its tax base.

The following will assist you further to understand the reasoning behind the recognition of deferred tax liabilities on taxable temporary differences.

(a) When an asset is recognised, it is expected that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods.

(b) If the carrying amount of the asset is greater than its tax base, then taxable economic benefits will also be greater than the amount that will be allowed as a deduction for tax purposes.

(c) The difference is therefore a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability.

(d) As the entity recovers the carrying amount of the asset, the taxable temporary difference will be progressively reversed and the entity will have taxable profit.

(e) It is then probable that economic benefits will flow from the entity in the form of tax payments, and so the recognition of deferred tax liabilities is required by SFRS(I) 1-12.

SFRS(I) 1-12 provides a number of examples of circumstances that give rise to taxable temporary differences.

3.1 Examples of taxable temporary differences

3.1.1 Transactions that affect the statement of profit or loss and other comprehensive income

A number of examples are provided in SFRS(I) 1-12 Illustrative Examples. They include:

(a) Depreciation of an asset may be accelerated for tax purposes. When new assets are purchased, allowances may be available against taxable profits which exceed the amount of depreciation.
chargeable on the assets in the financial accounts for the year of purchase. (Note: Depreciation is not tax deductible in Singapore.)

(b) **Development costs** which have been capitalised will be amortised in profit or loss, but may be an allowable deduction in full from taxable profit in the period in which they were incurred.

(Note: Familiarity with tax rules applicable to various jurisdictions is crucial to the correct application of SFRS(I) 1-12.)

**Example**

A company purchased an asset costing $1,500. At the end of 20X8 the carrying amount is $1,000. The cumulative capital allowances given to date are $900.

Calculate the taxable temporary difference for the asset.

**Solution**

- The carrying amount of the asset is $1,000.
- The tax base is $600 ($1,500 – $900).
- Therefore the taxable temporary difference is $400.

**3.1.2 Transactions that affect the statement of financial position**

The following are taken from SFRS(I) 1-12 Illustrative Examples. See Paragraphs 6–9 for full details.

- **Depreciation of an asset** is not deductible for tax purposes. No deduction will be available for tax purposes when the asset is sold/scrapped in Singapore.
- A borrower records a loan as proceeds received (amount due at maturity) less transaction costs. The carrying amount of the loan is subsequently increased by amortisation of the transaction costs against accounting profit. The transaction costs were, however, deducted for tax purposes in the period when the loan was first recognised.
- A loan payable is measured on initial recognition at net proceeds (net of transaction costs). The transaction costs are amortised to accounting profit over the life of the loan. Those transaction costs are not deductible in determining the taxable profit of future, current or prior periods.
- The liability component of a compound financial instrument (eg a convertible bond) is measured at a discount to the amount repayable on maturity, after assigning a portion of the cash proceeds to the equity component (see SFRS(I) 1-32). The discount is not deductible in determining taxable profit.

**3.1.3 Fair value adjustments and revaluations**

- **Current investments** or financial instruments are carried at fair value. This exceeds cost, but no equivalent adjustment is made for tax purposes.
- Property, plant and equipment is **revalued** by an entity (under SFRS(I) 1-16), but no equivalent adjustment is made for tax purposes. This also applies to long-term investments.

**Example**

Lucky Foods Ltd revalued a factory to $12,000,000 on 31 December 20X3. The property was purchased for $8,000,000 four years ago and was being depreciated over 50 years on a straight line basis. Capital allowances were provided on the property at 25% of cost in the first year and 3% of cost thereafter. The applicable tax rate is 17%. Any capital gains/losses on disposal of assets are taxable/deductible only in the year of disposal.
What deferred tax arises on the revaluation assuming that the revaluation gain does not form part of taxable income for the year ending 31 December 20X3?

Solution

Presumably, a deferred tax liability balance of $353,600 already exists in the statement of financial position. This is in respect of the taxable temporary difference between carrying amount (based on historic cost less accumulated depreciation) of $7.36m and tax base of $5.28m ($8m × 75% – (3yrs × $8m × 3%)) multiplied by the applicable tax rate.

Next, the deferred tax is calculated on the revaluation gain.

- The carrying amount of the factory prior to revaluation was $8m × 46/50 = $7.36m
- The revalued amount is $12m
- The revaluation gain of $4.64m is a taxable temporary difference
- Therefore an additional deferred tax liability of $4.64m × 17% = $788,800 is recorded

This can also be explained as follows.

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<th>Year</th>
<th>Reval'n surplus</th>
<th>Current book dep'n</th>
<th>YTD amount</th>
<th>Current carrying tax allowances</th>
<th>YTD tax</th>
<th>TWDV Current year</th>
<th>YTD tax vs book dep'n</th>
<th>Tax vs book dep'n</th>
<th>Current year YTD</th>
<th>CY DT (exp)</th>
<th>CR YTD SOFP DT Liab</th>
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<td>(788.80)</td>
<td>(1,142.40)</td>
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<td>(2,595)</td>
<td>3.55</td>
<td>(1,121.11)</td>
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</table>

Till year 50

Year 4 (in $’000)

DEBIT Non-current assets 4,640
CREDIT Asset revaluation surplus 3,851.20
CREDIT Deferred tax liability 788.80

Year 4 Deferred tax liability = (CA – TWDV) × 17% = (12,000 – 5,280) × 17% = $1,142k

3.2 Taxable temporary differences that do not result in deferred tax liabilities

While all taxable temporary differences give rise to a deferred tax liability, there are two circumstances given in the standard where the deferred tax liability shall not be recognised, i.e when:

(a) The deferred tax liability arises from the initial recognition of goodwill
(b) The deferred tax liability arises from the initial recognition of an asset or liability in a transaction which:
   (i) Is not a business combination (see Section 6 of this chapter); and
   (ii) At the time of the transaction affects neither accounting profit nor taxable profit.
3.3 Initial recognition of a deferred tax asset or liability

A temporary difference can arise on initial recognition of an asset or liability, eg if part or all of the cost of an asset will not be deductible for tax purposes. The nature of the transaction which led to the initial recognition of the asset is important in determining the method of accounting for such temporary differences.

If the transaction affects either accounting profit or taxable profit, an entity will recognise any deferred tax liability or deferred tax asset. The resulting deferred tax expense or income will be recognised in profit or loss.

Where a transaction affects neither accounting profit nor taxable profit it would be normal for an entity to recognise a deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount (unless exempted by SFRS(I) 1-12). However, SFRS(I) 1-12 does not permit this recognition of a deferred tax asset or liability as it would make the financial statements less transparent.

Example

As an example of the last paragraph, suppose Somerset Trading Ltd intends to use an asset which cost $10,000 as at 1 January 20X7 through its useful life of five years. Its residual value will then be nil. The tax rate is 17%. Any capital gain on disposal would not be taxable (and any capital loss not deductible). Depreciation of the asset is not deductible for tax purposes.

State the deferred tax consequences in each of years 20X7 and 20X8.

Solution

As at 1 January 20X7, the carrying amount of the asset is $10,000 and the tax base is $0. Note that as it recovers the carrying amount of the asset, Somerset Trading Ltd will earn taxable income of $10,000 and pay tax of $1,700 in the future. However, the resulting deferred tax liability of $1,700 would not be recognised because it results from the initial recognition of the asset.

As at 1 January 20X8, the carrying amount of the asset is now $8,000. In earning taxable income of $8,000, the entity will pay tax of $1,360. Again, the resulting deferred tax liability of $1,360 is not recognised because it results from the initial recognition of the asset.

Question 13.4

Prosperity Biscuits Ltd buys equipment at the start of 20X1 for $60,000 and depreciates it on a straight line basis over its expected useful life of five years. For tax purposes, the equipment is written off over three years. The tax rate is 17%.

Required

Assuming nil profits/losses after depreciation in years 20X1 to 20X5 show the current and deferred tax impact in years 20X1 to 20X5 of the acquisition of the equipment.

SECTION SUMMARY

Taxable temporary differences arise where the carrying amount of an item exceeds its tax base. A revaluation gain will result in a taxable temporary difference equal to the revaluation surplus recognised. Taxable temporary differences also arise as a result of accelerated capital allowances. They do not arise on the initial recognition of an asset or liability which is not a business combination nor from the initial recognition of goodwill.
4 Deductible temporary differences

SECTION INTRODUCTION
Deferred tax assets arise from deductible temporary differences.

As we have already seen, a deductible temporary difference arises where the carrying amount of an asset (liability) is less (greater) than its tax base.

Let us lay out the reasoning behind the recognition of deferred tax assets arising from deductible temporary differences.

(a) When a liability is recognised, it is assumed that its carrying amount will be settled in the form of outflows of economic benefits from the entity in future periods.

(b) When these resources flow from the entity, part or all may be deductible in determining taxable profits of a period later than that in which the liability is recognised.

(c) A temporary tax difference then exists between the carrying amount of the liability and its tax base.

(d) A deferred tax asset therefore arises, representing the income taxes that will be recoverable in future periods when that part of the liability is allowed as a deduction from taxable profit.

(e) Similarly, when the carrying amount of an asset is less than its tax base, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods.

4.1 Examples of deductible temporary differences

4.1.1 Transactions that affect the statement of profit or loss and other comprehensive income

Again, SFRS(I) 1-12 provides a number of examples of circumstances that result in deductible temporary differences and included in these are:

(a) Retirement benefit costs (pension costs) are deducted from accounting profit as service is provided by the employee. They are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. (This may also apply to similar expenses.)

(b) Accumulated depreciation of an asset in the financial statements is greater than the accumulated depreciation allowed for tax purposes up to the end of the reporting period.

(c) The NRV of inventory, or the recoverable amount of an item of property, plant and equipment falls and the carrying value is therefore reduced, but that reduction is ignored for tax purposes until the asset is sold.

(d) Research costs (or organisation/other start-up costs) are recognised as an expense for accounting purposes but are not deductible against taxable profits until a later period.

(e) Income is deferred/unearned in the statement of financial position, but has already been included in taxable profit in current/prior periods.

A 2016 amendment to SFRS(I) 1-12 (effective 1 January 2017) clarifies that unrealised losses on debt instruments measured at fair value in the financial statements but at cost for tax purposes can give rise to deductible temporary differences. This is regardless of whether the holder expects to recover the carrying amount of the debt instrument by holding it until maturity or by through sale.
Example

O Ltd recognises a liability of $100,000 for accrued product warranty costs on 31 December 20X7. These product warranty costs will not be deductible for tax purposes until the entity pays claims. The tax rate is 17%.

What is the temporary difference in respect of the liability?

Solution

- The carrying amount of the liability is $100,000.
- The tax base of the liability is nil (carrying amount of $100,000 less the amount that will be deductible for tax purposes in respect of the liability in future periods).
- The temporary difference is therefore $100,000.

(When the liability is settled for its carrying amount, the entity's future taxable profit will be reduced by $100,000 and so its future tax payments will be reduced by $100,000 × 17% = $17,000.)

4.1.2 Fair value adjustments and revaluations

Current investments or financial instruments may be carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

4.2 Recognition of deductible temporary differences

A deductible temporary difference will not necessarily result in a deferred tax asset.

Apart from the exceptions discussed later in Section 4.3, in order to be recognised a deferred tax asset must satisfy the recognition criteria given in SFRS(I) 1-12. This is that a deferred tax asset should be recognised for all deductible temporary differences to the extent that it is probable that future taxable profit will be available against which it can be utilised. This is an application of prudence.

4.2.1 Future taxable profits

When can we be sure that sufficient taxable profit will be available against which a deductible temporary difference can be utilised? SFRS(I) 1-12 states that this will be assumed when sufficient taxable temporary differences exist which relate to the same taxation authority and the same taxable entity. These should be expected to reverse as follows.

(a) In the same period as the expected reversal of the deductible temporary difference
(b) In periods into which a tax loss arising from the deferred tax asset can be carried back or forward

Only in these circumstances is the deferred tax asset recognised, in the period in which the deductible temporary differences arise.

What happens when there are insufficient taxable temporary differences (relating to the same taxation authority and the same taxable entity)? It may still be possible to recognise the deferred tax asset, but only to the following extent.

(a) Taxable profits are sufficient in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried forward or backward). In evaluating this, future taxable profit:

(i) Is the amount before any reversal of deductible temporary differences
(ii) Ignores taxable amounts arising from deductible temporary differences arising in future periods.

(b) **Tax planning opportunities** exist that will allow the entity to create taxable profit in the appropriate periods.

With reference to (b), **tax planning opportunities** are actions that an entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carryforward. For example, in some countries it may be possible to increase or create taxable profit by electing to have interest income taxed on either a received or receivable basis, or deferring the claim for certain deductions from taxable profit.

In any case, where tax planning opportunities advance taxable profit from a later period to an earlier period, the utilisation of a tax loss or a tax credit carryforward will still depend on the existence of future taxable profit from sources other than future originating temporary differences.

If an entity has a **history of recent losses**, then this is evidence that future taxable profit may not be available.

### 4.3 Deductible temporary differences that do not result in deferred tax assets

As with temporary taxable differences, there are also circumstances where the overall rule for recognition of deferred tax asset is **not** allowed. This applies where the deferred tax asset arises from **initial recognition** of an asset or liability in a transaction which is not a business combination, and at the time of the transaction, affects neither accounting nor taxable profit/tax loss.

The example given by the standard is of a non-taxable government grant related to an asset, deducted in arriving at the carrying amount of the asset. For tax purposes, however, it is **not** deducted from the asset's depreciable amount (ie its tax base). The carrying amount of the asset is less than its tax base and this gives rise to a deductible temporary difference, however this is not recognised as a deferred tax asset.

### 4.4 Unused tax losses and unused tax credits

An entity may have unused tax losses or credits (ie which it can offset against taxable profits) at the end of a period. Should a deferred tax asset be recognised in relation to such amounts? SFRS(I) 1-12 states that a deferred tax asset may be recognised in such circumstances **to the extent that it is probable future taxable profit will be available against which the unused tax losses/credits can be utilised**.

The **criteria for recognition** of deferred tax assets here are the same as for recognising deferred tax assets arising from deductible differences. The existence of **unused tax losses** is strong evidence, however, that future taxable profit may not be available. So where an entity has a history of recent tax losses, a deferred tax asset arising from unused tax losses or credits should be recognised only to the extent that the entity has sufficient taxable temporary differences or there is other convincing evidence that sufficient taxable profit will be available against which the unused losses/credits can be utilised by the entity.

In these circumstances, the following criteria should be considered when assessing the probability that taxable profit will be available against which unused tax losses/credits can be utilised.

- **Existence of sufficient taxable temporary differences** (same tax authority/taxable entity) against which unused tax losses/credits can be utilised before they expire
- **Probability that the entity will have taxable profits** before the unused tax losses/credits expire
- **Whether the unused tax losses result from identifiable causes**, unlikely to recur
- **Availability of tax planning opportunities** (see above)

To the extent that it is **not probable** that taxable profit will be available, the deferred tax asset is **not** recognised.
4.5 Reassessment of unrecognised deferred tax assets

For all unrecognised deferred tax assets, at each reporting period end an entity should re-assess the availability of future taxable profits and whether part or all of any unrecognised deferred tax assets should now be recognised. This may be due to an improvement in trading conditions which is expected to continue.

4.6 Summary

**SECTION SUMMARY**

Deductible temporary differences arise where the carrying amount of an item is less than its tax base. A deductible temporary difference results in a deferred tax asset, however only where sufficient future taxable profits are probable against which they can be utilised.

5 Measurement and recognition of deferred tax

**SECTION INTRODUCTION**

SFRS(I) 1-12 provides guidance on the relevant tax rate to apply when measuring a deferred tax asset or liability.
5.1 Basis of provision of deferred tax

SFRS(I) 1-12 requires that deferred tax be provided for on all temporary differences regardless of the plans of an entity – except to the extent that they arise from the initial recognition of goodwill; or the initial recognition of an asset or liability in a transaction which is not a business combination and at the time of the transaction affects neither accounting profit nor taxable profit (tax loss).

The full provision method has the advantage that it recognises that each temporary difference at the end of the reporting period has an effect on future tax payments. If a company claims an accelerated tax allowance on an item of plant, future tax assessments will be bigger than they would have been otherwise. Future transactions may well affect those assessments still further, but that is not relevant in assessing the position at the year-end. The disadvantage of full provision is that, under certain types of tax system, it gives rise to large liabilities that may fall due only far in the future.

5.2 Applicable rate of tax

SFRS(I) 1-12 requires that a deferred tax asset or liability is calculated using the rate of tax which is expected to apply in the period when the asset is realised or the liability settled based on tax laws enacted, or substantively enacted, at the period end. This is the liability method.

In addition, in some countries, different tax rates apply to different levels of taxable income. In such cases, deferred tax assets and liabilities should be measured using the average rates that are expected to apply to the taxable profit (loss) of the periods in which the temporary differences are expected to reverse.

5.2.1 Manner of recovery or settlement

In some countries, the way in which an entity recovers or settles the carrying amount of an asset or liability may affect the following.

(a) The tax rate applying when the entity recovers/settles the carrying amount of the asset/liability
(b) The tax base of the asset/liability

In such cases, the entity must consider the expected manner of recovery or settlement. Deferred tax liabilities and assets must be measured accordingly, using an appropriate tax rate and tax base.

Note that it is presumed that deferred tax on investment properties measured using the fair value model should be measured based on recovery through sale rather than use. The presumption is rebuttable. As there is no capital gains tax in Singapore this will generally result in the deferred tax liability on such investment properties being limited to the tax effect of any claw back on sale of any capital allowances previously given. No deferred tax arises in respect of the excess of fair value over cost.

Example

T Ltd has an asset with a carrying amount of $10,000 and a tax base of $6,000. The company operates in a jurisdiction where, if the asset were sold, a tax rate of 20% would apply. A tax rate of 30% would apply to other income.

State the deferred tax consequences if the entity:

(a) Sells the asset without further use
(b) Expects to retain the asset and recover its carrying amount through use

Solution

(a) A deferred tax liability is recognised of $(10,000 – 6,000) × 20% = $800.
(b) A deferred tax liability is recognised of $(10,000 – 6,000) × 30% = $1,200.
**Question 13.5**  
L Ltd has an asset which cost $100,000. In 20X9 the carrying amount was $80,000 and the asset was revalued to $150,000. No equivalent adjustment was made for tax purposes. Cumulative depreciation for tax purposes is $30,000 and the tax rate is 17%. If the asset is sold for more than cost, the cumulative tax depreciation of $30,000 will be included in taxable income but sale proceeds in excess of cost will not be taxable.

**Required**
State the deferred tax consequences of the above if L Ltd:
(a) Expects to recover its carrying amount through use
(b) Expects to sell the asset without further use

**Question 13.6**
The facts are as in Recovery 1 above, except that if the asset is sold for more than cost, the cumulative tax depreciation will be included in taxable income (taxed at 17%) and the sale proceeds will be taxed at 40% after deducting an inflation-adjusted cost of $110,000.

**Required**
State the deferred tax consequences of the above if L Ltd:
(a) Expects to recover its carrying amount through use
(b) Expects to sell the asset without further use

**5.3 Discounting**
SFRS(I) 1-12 states that deferred tax assets and liabilities should not be discounted because the complexities and difficulties involved will affect reliability. Discounting would require detailed scheduling of the timing of the reversal of each temporary difference, but this is often impracticable. If discounting were permitted, this would affect comparability, so it is barred completely. However, temporary differences are determined by reference to the carrying amount of an asset or liability. This applies even where that carrying amount is itself determined on a discounted basis, for example in the case of retirement benefit obligations.

**5.4 Carrying amount of deferred tax assets**
The carrying amount of deferred tax assets should be reviewed at the end of each reporting period and reduced where appropriate (due to the expectation of insufficient future taxable profits). Such a reduction may be reversed in future years.

**5.5 Recognition**
As with current tax, deferred tax should normally be recognised as income or an expense and included in the net profit or loss for the period.

The figures shown for deferred tax in profit or loss will consist of two components.
(a) Deferred tax relating to temporary differences.
(b) Adjustments relating to changes in the carrying amount of deferred tax assets/liabilities (where there is no change in temporary differences), eg changes in tax rates/laws, reassessment of the recoverability of deferred tax assets, or a change in the expected recovery of an asset.
The exceptions to recognition of deferred tax in profit or loss are where the tax arises from the events below.

(a) A transaction or event which is recognised (in the same or a different period) in other comprehensive income (eg a revaluation of PPE)

(b) A transaction or event which is recognised (in the same or a different period) directly in equity (eg the correction of an error)

(c) A business combination that is an acquisition (see Section 6 of the chapter)

SFRS(I) 1-12 clarifies that income tax consequences of dividends are recognised in profit or loss rather than equity, because the payment of dividends is linked more directly to past transactions or events that generated distributable profits rather than distributions to owners. An exception to this is when the transaction resulting in payment of a dividend is recognised outside profit or loss or is a business combination. The tax consequences are recognised when a liability to pay the dividend is recognised.

Where transactions or events are recognised in other comprehensive income or directly in equity, the related tax is recognised similarly.

Where it is not possible to determine the amount of current/deferred tax that relates to items credited/charged to equity, such tax amounts should be based on a reasonable pro rata allocation of the entity's current/deferred tax.

SECTION SUMMARY

A deferred tax asset or liability is measured by applying the tax rate, which is expected to apply to the period when the asset is realised or the liability is settled, to the temporary difference. Deferred tax assets and liabilities are not discounted. Deferred tax is recognised in profit or loss, except where it relates to other comprehensive income, a transaction recognised directly in equity or a business combination.

6 Deferred taxation and business combinations

SECTION INTRODUCTION

There are a number of deferred tax aspects of business combinations.

In relation to business combinations and consolidations, SFRS(I) 1-12 gives (in an appendix) examples of circumstances that give rise to taxable temporary differences and to deductible temporary differences.

6.1 Circumstances that give rise to taxable temporary differences

(a) The carrying amount of an asset is increased to fair value in a business combination that is an acquisition and no equivalent adjustment is made for tax purposes.

(b) Unrealised losses resulting from intra-group transactions are eliminated by inclusion in the carrying amount of inventory or property, plant and equipment.

(c) Retained earnings of subsidiaries, branches, associates and joint ventures are included in consolidated retained earnings, but income taxes will be payable if the profits are distributed to the reporting parent.
(d) Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates.

(e) An entity accounts in its own currency for the cost of the non-monetary assets of a foreign operation that is integral to the reporting entity’s operations but the taxable profit or tax loss of the foreign operation is determined in the foreign currency.

**Question 13.7**

**Deferred tax and business combinations 1**

What are the consequences of the above situations?

Note: You may want to read through to the end of this section before you attempt this question.

**6.2 Circumstances that give rise to deductible temporary differences**

(a) A liability is recognised at its fair value in a business combination that is an acquisition, but none of the related expense is deducted in determining taxable profit until a later period.

(b) Unrealised profits resulting from intra-group transactions are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes.

(c) Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates.

(d) A foreign operation accounts for its non-monetary assets in its own (functional) currency. If its taxable profit or loss is determined in a different currency (under the presentation currency method) changes in the exchange rate result in temporary differences. The resulting deferred tax is charged or credited to profit or loss.

**Question 13.8**

**Deferred tax and business combinations 2**

What are the consequences of the above situations?

Note: Again, you may decide to read to the end of this section before you answer this question.

**6.3 Taxable temporary differences**

In a business combination, the identifiable assets acquired and liabilities assumed are recognised at their fair values as at the date of the transaction. Temporary differences will arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner; a taxable temporary difference arises which results in a deferred tax liability and this will also affect goodwill.

**6.4 Deductible temporary differences**

In a business combination that is an acquisition when a liability is recognised on acquisition but the related costs are not deducted in determining taxable profits until a later period, a deductible temporary difference arises resulting in a deferred tax asset. A deferred tax asset will also arise when the fair value of an identifiable asset acquired is less than its tax base. In both these cases goodwill is affected (see below).
6.5 Investments in subsidiaries, branches and associates and interests in joint arrangements

When such investments are held, temporary differences arise because the carrying amount of the investment (ie the parent's share of the net assets including goodwill) becomes different from the tax base (often the cost) of the investment. Why do these differences arise? These are some examples.

(a) There are distributable profits held by subsidiaries, branches, associates and joint ventures.
(b) There are changes in foreign exchange rates when a parent and its subsidiary are based in different countries.
(c) There is a reduction in the carrying amount of an investment in an associate to its recoverable amount.

The temporary difference in the consolidated financial statements may be different from the temporary difference associated with that investment in the parent's separate financial statements when the parent carries the investment in its separate financial statements at cost or revalued amount.

SFRS(I) 1-12 requires entities to recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of these conditions are satisfied:

(a) The parent/investor/venturer is able to control the timing of the reversal of the temporary difference.
(b) It is probable that the temporary difference will not reverse in the foreseeable future.

As well as the fact of parent control over reversal of temporary differences, it would often be impracticable to determine the amount of income taxes payable when the temporary differences reverse. So when the parent has determined that those profits will not be distributed in the foreseeable future, the parent does not recognise a deferred tax liability. The same applies to investments in branches.

Where a foreign operation's taxable profit or tax loss (and therefore the tax base of its non-monetary assets and liabilities) is determined in a foreign currency, changes in the exchange rate give rise to temporary differences. These relate to the foreign entity's own assets and liabilities, rather than to the reporting entity's investment in that foreign operation, and so the reporting entity should recognise the resulting deferred tax liability or asset. The resulting deferred tax is charged or credited to profit or loss.

An investor in an associate does not control that entity and so cannot determine its dividend policy. Without an agreement requiring that the profits of the associate should not be distributed in the foreseeable future, an investor should therefore, recognise a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. Where an investor cannot determine the exact amount of tax, but can determine that it will equal or exceed a minimum amount, then the deferred tax liability should be that amount.

In a joint arrangement, the agreement between the parties usually deals with profit sharing. When a party to the arrangement can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, a deferred liability is not recognised.

SFRS(I) 1-12 then states that a deferred tax asset should be recognised for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent that (and only to the extent that) both these are probable:

(a) That the temporary difference will reverse in the foreseeable future; and
(b) That taxable profit will be available against which the temporary difference can be utilised.

The prudence principle discussed above for the recognition of deferred tax assets should be considered.
6.6 Deferred tax assets of an acquired subsidiary

Deferred tax assets of a subsidiary may not satisfy the criteria for recognition when a business combination is initially accounted for but may be realised subsequently.

These should be recognised as follows.

(a) If recognised within 12 months of the acquisition date and resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to goodwill. If the carrying amount of goodwill is reduced to zero, any further amounts should be recognised in profit or loss.

(b) If recognised outside the 12 months ‘measurement period’ or not resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to profit or loss.

Note: ‘Measurement period’ is referred to in SFRS(I) 3 Business Combinations (paragraph 45). This states that the measurement period must not exceed one year from the acquisition date.

Question 13.9

In 20X2 Orchard Fisheries Ltd acquired a subsidiary, Carp Ltd, which had deductible temporary differences of $3 million. The tax rate at the date of acquisition was 17%. The resulting deferred tax asset of $0.51 million was not recognised as an identifiable asset in determining the goodwill of $5 million resulting from the business combination. Two years after the acquisition, Orchard Fisheries decided that future taxable profit would probably be sufficient for the entity to recover the benefit of all the deductible temporary differences.

Required

(a) What accounting treatment is applied when the deferred tax asset is recognised in 20X4?

(b) What would happen if the tax rate had risen to 20% by 20X4 or decreased to 15%?

(c) How would this accounting treatment that you have described in (a) differ if the deferred tax asset were recognised within a year of the acquisition of Carp Ltd?

6.7 Further practice questions

Question 13.10

Red is a private limited liability company and has two 100% owned subsidiaries, Blue and Green, both themselves private limited liability companies. Red acquired Green on 1 January 20X2 for $5 million when the fair value of the net assets was $4 million, and the tax base of the net assets was $3.5 million. The acquisition of Green and Blue was part of a business strategy whereby Red would build up the ‘value’ of the group over a three-year period and then list its existing share capital on the SGX.

(a) The following details relate to the acquisition of Green, which manufactures electronic goods.

(i) Part of the purchase price has been allocated to intangible assets because it relates to the acquisition of a database of key customers from Green. The recognition and measurement criteria for an intangible asset under SFRS(I) 3 Business Combinations/SFRS(I) 1-38 Intangible Assets do not appear to have been met but the directors feel that the intangible asset of $0.5 million will be allowed for tax purposes and have computed the tax provision accordingly. However, the tax authorities could possibly challenge this opinion.

(ii) Green has sold goods worth $3 million to Red since acquisition and made a profit of $1 million on the transaction. The inventory of these goods recorded in Red’s statement of financial position at the year-end of 31 May 20X2 was $1.8 million.
(iii) The balance on the retained earnings of Green at acquisition was $2 million. The directors of Red have decided that, during the three years to the date that they intend to list the shares of the company, they will realise earnings through future dividend payments from the subsidiary amounting to $500,000 per year. Tax is payable on any remittance or dividends and no dividends have been declared for the current year.

(b) Blue was acquired on 1 June 20X1 and is a company which undertakes various projects ranging from debt factoring to investing in property and commodities. The following details relate to Blue for the year ending 31 May 20X2.

(i) Blue has a portfolio of readily marketable government securities which are held as current assets. These investments are stated at market value in the statement of financial position with any gain or loss taken to profit or loss for the year. These gains and losses are taxed when the investments are sold. Currently the accumulated unrealised gains are $4 million.

(ii) Blue has calculated that it requires a specific allowance of $2 million against loans in its portfolio. Tax relief is available when the specific loan is written off.

(iii) When Red acquired Blue, Blue had unused tax losses brought forward. At 1 June 20X1, it appeared that Blue would have sufficient taxable profit to realise the deferred tax asset created by these losses but subsequent events have proven that the future taxable profit will not be sufficient to realise all of the unused tax loss.

The current tax rate for Red is 17% and for public companies is 18%.

Required

Write a comprehensive note suitable for presentation to the partner of an accounting firm setting out the deferred tax implications of the above information for the Red Group of companies.

Question 13.11

You are the accountant of Payit Ltd. Your assistant is preparing the consolidated financial statements for the year ended 31 March 20X2. However, he is unsure how to account for the deferred tax effects of certain transactions as he has not studied SFRS(I) 1-12. These transactions are given below.

Transaction 1

During the year, Payit sold goods to a subsidiary for $10 million, making a profit of 20% on selling price. 25% of these goods were still in the inventories of the subsidiary at 31 March 20X2. The subsidiary and Payit are in the same tax jurisdiction and pay tax on profits at 17%.

Transaction 2

An overseas subsidiary made a loss adjusted for tax purposes of $8 million ($ equivalent). The only relief available for this tax loss is to carry it forward for offset against future taxable profits of the overseas subsidiary. Taxable profits of the overseas subsidiary suffer tax at a rate of 15%.

Required

Compute the effect of both the above transactions on the deferred tax amounts in the consolidated statement of financial position of Payit at 31 March 20X2. You should provide a full explanation for your calculations and indicate any assumptions you make in formulating your answer.

SECTION SUMMARY

Temporary differences arise as a result of business combinations and SFRS(I) 1-12 gives examples of circumstances which result in both taxable and deductible temporary differences.
7 Disclosures

SECTION INTRODUCTION

SFRS(I) 1-12 has extensive disclosure and presentation requirements.

Deferred tax assets and liabilities can be offset if, and only if:

(a) The entity has a legally enforceable right to set off current tax assets against current tax liabilities, and

(b) The deferred tax assets and liabilities relate to income taxes levied by the same taxation authority on either:
   (i) The same taxable entity; or
   (ii) Different taxable entities which intend to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

The following must be disclosed in relation to income taxes.

(a) The major components of tax expense in profit or loss including the current tax expense, adjustments in relation to the tax of previous periods and deferred tax expense/income amounts relating to the origination and reversal of temporary differences and changes in tax rates.

(b) The aggregate deferred tax relating to items that are charged or credited directly to equity.

(c) The amount of income tax relating to each component of other comprehensive income.

(d) An explanation of the relationship between tax expense and accounting profit.

(e) An explanation of changes in the applicable tax rates compared to the previous period.

(f) The amount of any deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised.

(g) In respect of each type of temporary difference:
   (i) The amount of deferred tax assets and liabilities recognised in the statement of financial position
   (ii) The amount of deferred tax income or expense recognised in profit or loss

(h) The amount of a deferred tax asset and the nature of evidence supporting its recognition when:
   (i) The utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and
   (ii) The entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.
Example

The following extract from the Singapore Airlines Annual Report FY2017/18 Deferred taxation note shows how movements in deferred tax are commonly reported.


17 Deferred Taxation (in $ million)

Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset current income tax assets against current income tax liabilities and when the deferred income taxes relate to the same fiscal authority. The amounts determined after appropriate offsetting are shown on the statements of financial position as follows:

<table>
<thead>
<tr>
<th>Statement of financial position 31 March</th>
<th>Profit and loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Group</td>
<td>FY2017/18</td>
</tr>
<tr>
<td>------------------------------------------</td>
<td>-----------</td>
</tr>
<tr>
<td>2018</td>
<td>2017</td>
</tr>
</tbody>
</table>

The deferred taxation arises as a result of:

Deferred tax liabilities

- Differences in depreciation
  - Revaluation to fair value
    - fuel hedging contracts
    - currency hedging contracts
    - cross currency swap contracts
    - financial assets measured at FVOCI
  - Fair value adjustments on acquisition of a subsidiary company
- Other temporary differences

Gross deferred tax liabilities

<table>
<thead>
<tr>
<th>The Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of financial position 31 March</td>
</tr>
<tr>
<td>------------------------------------------</td>
</tr>
<tr>
<td>The Group</td>
</tr>
<tr>
<td>------------------------------------------</td>
</tr>
<tr>
<td>2018</td>
</tr>
</tbody>
</table>

Deferred tax assets

- Unabsorbed capital allowances and tax losses
- Revaluation to fair value
  - fuel hedging contracts
  - currency hedging contracts
  - cross currency swap contracts
  - interest rate cap contracts
- Actuarial loss on revaluation of defined benefit plans
- Other temporary differences

Gross deferred tax assets

Net deferred tax liabilities

Deferred tax charged to profit and loss

Deferred tax charged to equity
Movement in deferred income tax account is as follows:

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning of financial year</td>
<td>4,269</td>
<td>2,626</td>
</tr>
<tr>
<td>Currency translation differences</td>
<td>27</td>
<td>163</td>
</tr>
<tr>
<td>Acquisition of subsidiary</td>
<td>245</td>
<td></td>
</tr>
<tr>
<td>Tax charge to profit or loss (Note 11)</td>
<td>645</td>
<td>1,480</td>
</tr>
<tr>
<td>End of financial year</td>
<td>5,186</td>
<td>4,269</td>
</tr>
</tbody>
</table>

At the end of the reporting period, deferred tax liability of $0.7 million (2017: $0.17 million) has been recognised for taxes that would be payable on the undistributed earnings of one of the Group's subsidiary companies.

For the other subsidiary companies of the Group, no deferred tax liability has been recognised as the Group has determined that undistributed earnings of these subsidiary groups will not be distributed in the foreseeable future. Such temporary differences for which no deferred tax liability has been recognised aggregate to $9.9 million (2017: $8.5 million). The deferred tax liability is estimated to be $3.0 million (2017: $2.6 million).

At the end of the reporting period, deferred tax liability of $0.7 million (2017: $0.17 million) has been recognised for taxes that would be payable on the undistributed earnings of one of the Group's subsidiary companies.

For the other subsidiary companies of the Group, no deferred tax liability has been recognised as the Group has determined that undistributed earnings of these subsidiary groups will not be distributed in the foreseeable future. Such temporary differences for which no deferred tax liability has been recognised aggregate to $9.9 million (2017: $8.5 million). The deferred tax liability is estimated to be $3.0 million (2017: $2.6 million).

### SECTION SUMMARY

Disclosure must be made of tax amounts recognised in profit or loss, other comprehensive income and equity together with details of changes in tax rates, the relationship between tax expense and accounting profit and details of temporary differences including those deductible temporary differences for which an asset is not recognised.

### Related interpretations

### SECTION INTRODUCTION

SFRS(I) INT 1-25 clarifies how a change in the tax status of an entity or its shareholders should be reported; SFRS(I) INT 23 deals with accounting for tax when it is unclear how tax legislation will apply to a transaction.

### 8.1 SFRS(I) INT 1-25 Income Taxes – Changes in the Tax Status of an Entity or its Shareholders

A change in the tax status of an entity or its shareholders may increase or decrease its tax liabilities or assets.

Such a change in status may be due to:

- The public listing of an entity's equity instruments
- The restructuring of an entity's equity
- A controlling shareholder's move to a foreign country
The change in tax status may, for example, mean that an entity gains or loses tax incentives or becomes subject to a different rate of tax in the future. There may be an immediate effect on the entity's current tax liabilities or assets and the change may also increase or decrease the deferred tax liabilities and assets recognised by the entity.

SFRS(I) INT 1-25 concludes that:

(a) A change in the tax status of an entity or its shareholders does not result in increases or decreases in amounts recognised outside profit or loss.

(b) The current and deferred tax consequences of a change in tax status are included in net profit or loss for the period, unless they relate to transactions and events that are recognised in equity or in other comprehensive income. Tax consequences relating to transactions and events that are recognised in equity or in other comprehensive income are also recognised in equity or in other comprehensive income.

8.2 SFRS(I) INT 23 Uncertainty over Income Tax Treatments

This interpretation addresses the determination of taxable profits or losses, tax bases, unused tax losses or credits and tax rates in instances when it is unclear how tax law should apply to a transaction, and the final outcome, to be determined by tax authorities, is unknown at the reporting date.

It concludes that an entity should consider whether it is probable that tax authorities will accept each tax treatment that it intends to use in its tax filing.

- If acceptance is probable, the entity should determine taxable profits or losses, tax bases, unused tax losses or credits and tax rates consistently with the tax treatment used or planned to be used by the entity.

- If acceptance is not probable, the entity should reflect the effect of the uncertainty in determining the taxable profits or losses, tax bases, unused tax losses or credits and tax rates using either the most likely amount (the single most likely amount in a range of possible outcomes) or the expected value (the weighted average of a range of possible outcomes) of the tax treatment.

No new disclosures are required by the interpretation; however, it does emphasise that reporting entities should consider whether additional information about judgements and uncertainties is required in line with the requirements of IAS 1 (SFRS(I) 1-1).

SECTION SUMMARY

SFRS(I) INT 1-25 concludes that the current and deferred tax consequences of the change in tax status are recognised in the same way as the underlying transaction or event, in profit or loss or in other comprehensive income or in equity.

SFRS(I) INT 23 concludes that the determination of uncertain tax items depends on whether it is probable that the tax authorities will accept each tax treatment in its tax filing.
Quick Quiz

1. What is the difference between 'current tax' and 'deferred tax'?

2. How should current tax be measured in the statement of financial position?
   A. The total liability, including deferred tax
   B. The amount to be paid to (or recovered from) the tax authorities
   C. The amount calculated on accounting profit at current tax rates
   D. The amount calculated on accounting profit at future tax rates

3. A taxable temporary difference generally gives rise to a deferred tax liability. True or false?

4. Current tax assets and liabilities cannot be offset. True or false?

5. How do temporary differences arise when investments are held in subsidiaries, associates and so on?
Answers to Quick Quiz

1. (a) Current tax is the amount actually payable to the tax authorities.
   (b) Deferred tax is used to match the tax effects of transactions with their accounting impact.
2. B The amount expected to be paid to (or recovered from) the tax authorities.
3. True (see SFRS(I) 1-12 para. 15 for exceptions to the general rule).
4. False. They can be offset only if the entity has a legally enforceable right to offset and it intends to actually carry out the offset.
5. When the carrying amounts of the investment become different to the tax base of the investment.

Answers to Questions

13.1 Current tax

(a)

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax due on 20X8 profits ($120,000 × 8.5%)</td>
<td>10,200</td>
</tr>
<tr>
<td>Under provision for 20X7</td>
<td>2,000</td>
</tr>
<tr>
<td>Tax charge and liability</td>
<td>12,200</td>
</tr>
</tbody>
</table>

(b)

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax due on 20X8 profits (as above)</td>
<td>10,200</td>
</tr>
<tr>
<td>Overprovision for 20X7</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Tax charge and liability</td>
<td>9,200</td>
</tr>
</tbody>
</table>

Alternatively, the rebate due could be shown separately as income in the statement of profit or loss and other comprehensive income and as an asset in the statement of financial position. An offset approach like this is, however, more likely.

13.2 Tax base 1

(a) The tax base of the machine is $7,000.
(b) The tax base of the interest receivable is nil.
(c) The tax base of the trade receivables is $10,000.
(d) The tax base of the loan is $1m.
(e) The tax base of the dividends is $5,000.

In the case of (e), in substance the entire carrying amount of the asset is deductible against the economic benefits. There is no taxable temporary difference. An alternative analysis is that the accrued dividends receivable have a tax base of nil and a tax rate of nil is applied to the resulting taxable temporary difference ($5,000). Under both analyses, there is no deferred tax liability.

13.3 Tax base 2

(a) The tax base of the accrued expenses is nil.
(b) The tax base of the interest received in advance is nil.
(c) The tax base of the accrued expenses is $2,000.
(d) The tax base of the accrued fines and penalties is $100.
(e) The tax base of the loan is $1m.
13.4 Deferred tax

The temporary differences associated with the equipment and the resulting deferred tax asset and liability and deferred tax expense and income are as follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
<th>20X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount</td>
<td>$48,000</td>
<td>$36,000</td>
<td>$24,000</td>
<td>$12,000</td>
<td>$0</td>
</tr>
<tr>
<td>Tax base</td>
<td>$40,000</td>
<td>$20,000</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Taxable temporary difference</td>
<td>$8,000</td>
<td>$16,000</td>
<td>$24,000</td>
<td>$12,000</td>
<td>$0</td>
</tr>
<tr>
<td>Less: Opening deferred tax liability</td>
<td>$0</td>
<td>$1,360</td>
<td>$2,720</td>
<td>$4,080</td>
<td>$2,040</td>
</tr>
<tr>
<td>Deferred tax expense (income): bal fig</td>
<td>$1,360</td>
<td>$1,360</td>
<td>$1,360</td>
<td>$(2,040)</td>
<td>$(2,040)</td>
</tr>
<tr>
<td>Closing deferred tax liability@17%</td>
<td>$1,360</td>
<td>$2,720</td>
<td>$4,080</td>
<td>$2,040</td>
<td>$0</td>
</tr>
</tbody>
</table>

The entity recognises the deferred tax liability in years 20X1 to 20X4 because the reversal of the taxable temporary difference will create taxable income in subsequent years. The entity's statement of profit or loss and other comprehensive income is as follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
<th>20X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>$12,000</td>
<td>$12,000</td>
<td>$12,000</td>
<td>$12,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$12,000</td>
<td>$12,000</td>
<td>$12,000</td>
<td>$12,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Current tax expense (income)</td>
<td>$(1,360)</td>
<td>$(1,360)</td>
<td>$(1,360)</td>
<td>$2,040</td>
<td>$2,040</td>
</tr>
<tr>
<td>Deferred tax expense (income)</td>
<td>$1,360</td>
<td>$1,360</td>
<td>$1,360</td>
<td>$(2,040)</td>
<td>$(2,040)</td>
</tr>
<tr>
<td>Total tax expense (income)</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Net profit for the year</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

13.5 Recovery 1

The carrying amount of the asset is the revalued amount of $150,000

The tax base of the asset is $70,000 ($100,000 – $30,000).

If the entity expects to recover the carrying amount by using the asset it must generate taxable income of $150,000, but will only be able to deduct depreciation of $70,000. On this basis there is a deferred tax liability of $13,600 ($80,000 × 17%).

If the entity expects to recover the carrying amount by selling the asset immediately for proceeds of $150,000, the deferred tax liability will be computed as follows.

| Taxable temporary difference | $30,000 | 17% | $5,100 |
| Proceeds in excess of cost | $50,000 | Nil | $- |
| Total | $80,000 | | $5,100 |

13.6 Recovery 2

If the entity expects to recover the carrying amount by using the asset, the situation is as in Recovery 1 above in the same circumstances.

If the entity expects to recover the carrying amount by selling the asset immediately for proceeds of $150,000, the entity will be able to deduct the indexed costs of $110,000. The net profit of $40,000 will be taxed at 40%. In addition, the cumulative tax depreciation of $30,000 will be included in taxable income and taxed at 17%. On this basis, the tax base is $80,000 ($110,000 – $30,000), there is a taxable temporary difference of $70,000 and there is a deferred tax liability of $21,100 ($40,000 × 40% plus $30,000 × 17%).
13.7 Deferred tax and business combinations 1

(a) **Fair value adjustment**
On initial recognition, the resulting deferred tax liability increases goodwill or decreases negative goodwill.

(b) **Unrealised losses**
The tax bases of the assets are unaltered.

(c) **Consolidated earnings**
SFRS(I) 1-12 does not allow recognition of the resulting deferred tax liability if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

(d) **Changes in exchange rates: investments**
There may be either a taxable temporary difference or a deductible temporary difference in this situation. SFRS(I) 1-12 does not allow recognition of the resulting deferred tax liability if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

(e) **Changes in exchange rates: use of own currency**
Again, there may be either a taxable temporary difference or a deductible temporary difference. Where there is a taxable temporary difference, the resulting deferred tax liability is recognised, because it relates to the foreign operation's own assets and liabilities, rather than to the reporting entity's investment in that foreign operation. The deferred tax is charged to profit or loss.

13.8 Deferred tax and business combinations 2

(a) **Fair value of liabilities**
The resulting deferred tax asset decreases goodwill or increases negative goodwill.

(b) **Unrealised profits**
The tax bases of the assets are unaltered.

(c) **Changes in exchange rates: investments**
As noted in the question before this, there may be a taxable temporary difference or a deductible temporary difference. SFRS(I) 1-12 requires recognition of the resulting deferred tax asset to the extent, and only to the extent, that it is probable that:

(i) The temporary difference will reverse in the foreseeable future; and
(ii) Taxable profit will be available against which the temporary difference can be utilised.

(d) **Changes in exchange rates: use of own currency**
As noted in the question before this, there may be either a taxable temporary difference or a deductible temporary difference. Where there is a deductible temporary difference, the resulting deferred tax asset is recognised to the extent that it is probable that sufficient taxable profit will be available, because the deferred tax asset relates to the foreign operation's own assets and liabilities, rather than to the reporting entity's investment in that foreign operation. The deferred tax is charged to profit or loss.

13.9 Recognition

(a) In 20X4 the entity recognises a deferred tax asset of $0.51m ($3m $17%) and, in the statement of profit or loss, deferred tax income of $0.51m. No adjustment is made to goodwill as 20X4 is outside the SFRS(I) 3 measurement period (which lasts a maximum of 12 months from the acquisition date).
(b) If the tax rate rises to 20%, the entity should recognise a deferred tax asset of $0.6m ($3m × 20%) and, in profit or loss, deferred tax income of $0.6m.
If the tax rate falls to 15%, the entity should recognise a deferred tax asset of $0.45m ($3m × 15%) and deferred tax income of $0.45m.

(c) If the deferred tax asset were recognised within the measurement period i.e. within a year of the acquisition date, the credit entry of $0.51m would be made to goodwill rather than profit or loss. As a result the carrying amount of goodwill would be reduced by $0.51m.

13.10 Red

Acquisition of the subsidiaries – general

Fair value adjustments have been made for consolidation purposes in both cases and these will affect the deferred tax charge for the year. This is because the deferred tax position is viewed from the perspective of the group as a whole. For example, it may be possible to recognise deferred tax assets which previously could not be recognised by individual companies, because there are now sufficient tax profits available within the group to utilise unused tax losses. Therefore a provision should be made for temporary differences between fair values of the identifiable net assets acquired and their corresponding tax base ($4 million less $3.5 million in respect of Green). No provision should be made for the temporary difference of $1 million arising on goodwill recognised as a result of the combination with Green.

Future listing

Red plans to seek a listing in three years' time. Therefore it will become a public company and will be subject to a higher rate of tax. SFRS(I) 1-12 states that deferred tax should be measured at the average tax rates expected to apply in the periods in which the temporary differences are expected to reverse, based on current enacted tax rates and laws. This means that Red may be paying tax at the higher rate when some of its differences reverse and this should be taken into account in the calculation.

Acquisition of Green

(a) The directors have calculated the tax provision on the assumption that the intangible asset of $0.5 million will be allowed for tax purposes. However, this is not certain and the directors may eventually have to pay the additional tax. If the directors cannot be persuaded to adjust their calculations a liability for the additional tax should be recognised.

(b) The intra-group transaction has resulted in an unrealised profit of $0.6 million in the individual company accounts of Green, which is eliminated on consolidation. Green's tax charge, which forms part of the tax charge in the group statement of profit or loss and other comprehensive income is not, however, adjusted – it includes the tax on this profit. From the perspective of the group, there is therefore a temporary difference. Because the temporary difference arises in the financial statements of Red, deferred tax should be provided on this difference (an asset) using the rate of tax payable by Red.

(c) Deferred tax should be recognised on the unremitted earnings of subsidiaries unless the parent is able to control the timing of dividend payments or it is unlikely that dividends will be paid for the foreseeable future. Red controls the dividend policy of Green and this means that there would normally be no need to make a provision in respect of unremitted profits. However, the profits of Green will be distributed to Red over the next few years and tax will be payable on the dividends received. Therefore a deferred tax liability should be shown.

Acquisition of Blue

(a) A temporary difference arises where non-monetary assets are revalued upwards and the tax treatment of the surplus is different from the accounting treatment. In this case, the revaluation surplus has been recognised in profit or loss for the current period, rather than in equity but no corresponding adjustment has been made to the tax base of the investments because the gains will be taxed in future periods. Therefore the company should recognise a deferred tax liability on the temporary difference of $4 million.
(b) A temporary difference arises when the provision for the loss on the loan portfolio is first recognised. The general allowance is expected to increase and therefore it is unlikely that the temporary difference will reverse in the near future. However, a deferred tax asset should still be recognised. SFRS(I) 1-12 states that deferred tax assets should not be recognised unless it is probable that taxable profits will be available against which the taxable profits can be utilised. This is affected by the situation in point (c) below.

(c) In theory, unused tax losses give rise to a deferred tax asset. However, SFRS(I) 1-12 states that deferred tax assets should only be recognised to the extent that they are regarded as recoverable. They should be regarded as recoverable to the extent that on the basis of all the evidence available it is probable that there will be suitable taxable profits against which the losses can be recovered. The future taxable profit of Blue will not be sufficient to realise all the unused tax loss. Therefore the deferred tax asset is reduced to the amount that is expected to be recovered.

This reduction in the deferred tax asset implies that it was overstated at 1 June 20X1, when it was acquired by the group. As these are the first post-acquisition financial statements, goodwill should also be adjusted.

13.11 Payit Ltd

Transaction 1

This intra-group sale will give rise to a provision for unrealised profit on the unsold inventory of $10,000,000 \times 20\% \times 25\% = $500,000. This provision must be made in the consolidated accounts. However, this profit has already been taxed in the financial statements of Payit. In other words there is a temporary difference. In the following year when the stock is sold outside the group, the provision will be released, but the profit will not be taxed. The temporary difference therefore gives rise to a deferred tax asset. The asset is $17\% \times $500,000 = $85,000.

Deferred tax assets are recognised to the extent that they are recoverable. This will be the case if it is more likely than not that suitable tax profits will exist from which the reversal of the temporary difference giving rise to the asset can be deducted. The asset is carried forward on this assumption.

Transaction 2

An unused tax loss gives rise to a temporary difference because the loss is recognised in the financial statements but not yet allowed for tax purposes. When the overseas subsidiary generates sufficient taxable profits, the loss will be offset against these in arriving at taxable profits.

The amount of the deferred tax asset to be carried forward is 15\% \times $8m = $1.2m.

As with Transaction 1, deferred tax assets are recognised to the extent that they are recoverable. This will be the case if it is more likely than not that suitable tax profits will exist from which the reversal of the temporary difference giving rise to the asset can be deducted.
An increasing number of companies and other entities now provide employee benefits as part of their employees' remuneration package. In view of this trend, it is important that there is standard best practice for the way in which employee benefit costs are recognised, measured, presented and disclosed in the sponsoring entities' accounts. Generally, net liabilities are more common in the context of SFRS(I) 1-19. Net assets, while rare, may arise as well.
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measurement and Reporting (liabilities)</td>
<td></td>
</tr>
<tr>
<td>Apply, explain and evaluate accounting standards for major classes of liabilities insofar as they affect initial recognition, measurement (including initial measurement and subsequent re-measurement), classification and disclosure and de-recognition from an entity's statement of financial position.</td>
<td>3</td>
</tr>
<tr>
<td>Specific Application</td>
<td></td>
</tr>
<tr>
<td>Apply the relevant accounting treatment on the following classes of liabilities: employee benefits.</td>
<td>3</td>
</tr>
<tr>
<td>Emerging Trends</td>
<td></td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments.</td>
<td>1</td>
</tr>
</tbody>
</table>

ESSENTIAL READING

SFRS(I) 1-19 Employee Benefits

SECTION INTRODUCTION

SFRS(I) 1-19 Employee Benefits is a long and complex standard covering both short-term and long-term (post-employment) benefits.

Before we look at SFRS(I) 1-19, we should consider the nature of employee benefit costs and why there is an accounting problem which must be addressed by a standard.

1.1 The conceptual nature of employee benefit costs

When a company or other entity employs a new worker, that worker will be offered a package of pay and benefits. Some of these will be short-term and the employee will receive the benefit at about the same time as he or she earns it, for example basic pay, overtime and so on. Other employee benefits are deferred and will be received at some point in the future. The most common example of deferred benefits worldwide is retirement benefits (i.e. a pension) although, as we shall see in Section 3 below, retirement benefit plans are relatively rare in Singapore.

The cost of these deferred employee benefits to the employer can be viewed in various ways. They could be described as deferred salary to the employee. Alternatively, they are a deduction from the employee's true gross salary, used as a tax-efficient means of saving. In some countries, tax efficiency arises on retirement benefit contributions because they are not taxed in the hands of the employee, but they are allowed as a deduction from taxable profits of the employer.
1.2 Accounting for employee benefit costs

Accounting for short-term employee benefit costs tends to be quite straightforward, because the cost of providing such benefits is generally recognised as an expense in the employer's financial statements in the period in which the benefit is provided.

Accounting for the cost of deferred employee benefits is much more difficult. This is because of the large amounts involved, as well as the long time scale, complicated estimates and uncertainties. In the past, entities accounted for these benefits simply by charging actual payments made to the profit or loss of the employing entity. This led to substantial variations in reported profits of these entities and disclosure of information on these costs was usually sparse.

1.3 SFRS(I) 1-19 Employee Benefits

SFRS(I) 1-19 addresses the problem of accounting for employee benefit costs described above. It is intended to prescribe how employee benefits should be measured and recognised.

Note that SFRS(I) 1-19 does not apply to accounting performed by the Retirement Benefit Plans themselves. This is covered by SFRS(I) 1-26 Accounting and Reporting by Retirement Benefit Plans. Nor does SFRS(I) 1-19 apply to share-based payments used to reward employees for service; these are covered by SFRS(I) 2 Share-based Payment.

As a basic rule, SFRS(I) 1-19 states the following.

(a) A liability should be recognised at the period-end when an employee has provided a service in exchange for benefits to be received by the employee at some time in the future.

(b) An expense should be recognised when the entity consumes the economic benefits from a service provided by an employee in exchange for employee benefits.

The standard applies these principles to four categories of employee benefits, and proposes a different accounting treatment for each. These four categories are:

1. Short-term benefits including, if expected to be settled wholly before 12 months after the end of the annual reporting period in which the employees render the related services:
   - Wages and salaries
   - Central Provident Fund contributions
   - Paid annual leave
   - Paid sick leave
   - Paid maternity/paternity leave
   - Profit sharing and bonuses
   - Paid military service and reservist training
   - Non-monetary benefits, eg medical care, housing, cars, free or subsidised goods

2. Post-employment benefits, eg pensions and post-employment medical care and post-employment insurance

3. Other long-term benefits, eg profit shares, bonuses or deferred compensation payable later than 12 months after the period-end, sabbatical leave, long-service benefits and long-term disability benefits

4. Termination benefits, eg early retirement payments and redundancy payments

Benefits may be paid to the employees themselves, to their dependants (spouses, children, etc) or to third parties.
Each of these benefits is dealt with in turn in this chapter, but first there are a number of important definitions in SFRS(I) 1-19.

1.4 Definitions

SFRS(I) 1-19 uses a great many important definitions. This section lists those that relate to the different categories of employee benefits. Further definitions relevant to a particular type of benefit are explained in the relevant sections of the chapter.

KEY TERMS

EMPLOYEE BENEFITS are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.

SHORT-TERM EMPLOYEE BENEFITS are employee benefits (other than termination benefits) that are expected to be settled wholly before 12 months after the end of the annual reporting period in which the employees render the related service.

POST-EMPLOYMENT BENEFITS are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

OTHER LONG-TERM EMPLOYEE BENEFITS are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

TERMINATION BENEFITS are employee benefits provided in exchange for the termination of an employee's employment as a result of either:

(a) An entity's decision to terminate an employee's employment before the normal retirement date; or

(b) An employee's decision to accept an offer of benefits in exchange for the termination of employment.

SECTION SUMMARY

SFRS(I) 1-19 prescribes the accounting treatment applicable to short-term employee benefits, post-employment benefits, other long-term benefits and termination benefits. In particular it addresses the issue of how to account for deferred benefits which are provided in respect of service at the present time.

2 Short-term employee benefits

SECTION INTRODUCTION

The accounting for short-term employee benefits is simple. The principles are the same as for any expense that is accrued over a period.
As mentioned earlier, short-term benefits include monetary benefits such as salary, sick leave and annual bonuses and non-monetary benefits (benefits in kind) such as company cars and medical care. Some benefits may be awarded under statutes such as the Employment Act, which provides for paid Public Holidays, annual leave and sick leave. However, not all employees are covered by the Employment Act and, even where they are, employers may provide benefits in excess of the statutory minima. Therefore, sources such as employment contracts and employee handbooks should also be consulted for details of entitlements.

2.1 Recognition and measurement

The rules for short-term benefits are essentially an application of basic accounting principles and practice. Such benefits are recognised:

(a) As an expense in the period when the economic benefit is given (except insofar as employment costs may be included within the cost of an asset, e.g., property, plant and equipment when required by another standard).

(b) As a liability to the extent that they are unpaid. If the amount already paid exceeds the undiscounted amount of the benefits, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or cash refund.

Any short-term benefits paid in advance should be recognised as a prepayment (to the extent that it will lead to, e.g., a reduction in future payments or a cash refund).

SFRS(I) 1-19 explains how these rules are applied to short-term compensated absences and profit-sharing and bonus plans.

2.1.1 Short-term paid absences

Short-term paid absences are absences for which an employee is paid, such as holiday leave, sick leave, or maternity leave.

These are classified as either accumulating paid absences or non-accumulating paid absences.

<table>
<thead>
<tr>
<th>Short-term paid absences</th>
<th>Accumulating</th>
<th>Non-accumulating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Can be carried forward to future periods if entitlement not used in current period</td>
<td>Eg. holiday leave</td>
<td>Eg. maternity/ paternity pay, sick leave</td>
</tr>
<tr>
<td>Employee is paid for absence when it occurs but entitlement does not accumulate</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The accounting treatment of each type of short-term paid absence is as follows:

- **Accumulating short-term paid absences**
  - Recognise as an expense when the employee provides the service which entitles them to the absence.
  - Recognise a liability where there is an unused entitlement at the reporting date.
  - The amount to be recognised as a liability is the expected cost of accumulated paid absences, that is the additional amount the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period.

- **Non-accumulating short-term paid absences**
  - Recognise as an expense when the absences occur.
Question 14.1  Sick leave

SingTravel Pte Ltd has 100 employees. Each is entitled to five working days of paid sick leave for each year, and unused sick leave can be carried forward for one year. Sick leave is taken on a LIFO basis (ie first out of the current year's entitlement and then out of any balance brought forward).

As at 31 December 20X8, the average unused entitlement is two days per employee. SingTravel expects (based on past experience which is expected to continue) that 92 employees will take five days or less sick leave in 20X9, the remaining eight employees will take an average of 6½ days each.

Required

(a) State the required accounting for sick leave for SingTravel in the financial statements for the year ended 31 December 20X8.

(b) Explain how your answer in (a) would change if the sick leave was non-accumulating.

2.1.2 Profit sharing or bonuses

Profit sharing or bonuses payable within 12 months after the end of the accounting period should be recognised when:

(a) The entity has a present legal or constructive obligation to pay it
(b) A reliable estimation of the amount can be made

A present obligation exists when the entity has no realistic alternative but to make the payments.

A reliable estimation of the amount can be made when:

- The terms of a bonus plan contain a formula for determining the amount of the bonus;
- The entity determines the amounts to be paid before the financial statements are authorised for issue; or
- Past practice provides clear evidence of the amount of the constructive obligation.

Where there is a measurable present obligation, an expense and corresponding liability are recognised.

Further points to note:

(a) Profit sharing or the payment of a bonus are compensation for employee services and so are recognised as an expense, not as a distribution of profit.
(b) If profit share or bonus payments are not expected to be settled in full before 12 months after the end of the period in which employees render service, they are accounted for as other long-term employee benefits.

Example

Orchard Trees Pte Ltd has a profit sharing plan which requires it to pay a specified proportion of its profit to employees who are employed by the company throughout the year. If no employees leave during the year, the total profit-sharing payments amount to 3% of its net profit. However the company estimates that staff turnover will reduce the total payments to 2.5% of profit.

Explain the amount and accounting treatment of the profit share.

Solution

Since the best estimate of the amount to be paid is 2.5% of profit rather than 3%, Orchard Trees should recognise a liability and an expense of 2.5% of net profit. This will be debited to profit or loss as an expense and credited to liability.
2.1.3 Constructive obligation

An entity may have no legal obligation to pay a bonus but may have a practice of doing so. In such cases the entity has a constructive obligation to do so, if it has no realistic alternative but to pay; for example, failure to pay an established bonus could cause unacceptable damage to relationships with employees.

An example of this is the Annual Wage Supplement (AWS) or 13th month. In some cases this payment may be included in employment contracts or employee handbooks, but in other cases it may not be included in these documents. However employee morale would be damaged if such a bonus were not paid, so this could be deemed to be a constructive obligation.

SECTION SUMMARY

Short-term employment benefits are recognised as an expense in the period when the employee provides the service to which they relate (unless this amount may be capitalised within an asset in accordance with another standard). Employee benefits also form a liability to the extent that they are unpaid at the reporting date.

3 Post-employment benefits

SECTION INTRODUCTION

There are two types of post-employment benefit plan:

1. Defined contribution plans
2. Defined benefit plans

Many employers provide post-employment benefits for their employees after they have stopped working. **Pension funds** are the most obvious example, but an employer might provide post-employment death benefits to the dependants of former employees, or post-employment medical care.

Pension funds or plans are common in many parts of the world. The ‘plan’ receives regular contributions from the employer (and sometimes from current employees as well) and the money is invested in assets, such as stocks and shares and other investments. The post-employment benefits (pensions or other benefits) are paid out of the income from the plan assets (dividends, interest) or from money from the sale of some plan assets.

In Singapore, because of the existence of the Central Provident Fund (CPF), very few entities will operate, or contribute to, pension plans for their employees. However SFRS(I) 1-19 contains comprehensive coverage of how entities should account for pension obligations. Although this is not something you are likely to encounter much in your real-life work, you may need to consider pension contributions in the following situations.

- A Singapore company may contribute to pensions for employees in overseas locations. For example, Singapore Airlines had a defined benefit expense of $11.0m in 2017–18 in respect of such contributions.
- A Singapore company may have overseas subsidiaries which operate such plans.
- A Singapore company may operate a ‘Section 5’ plan (see below).
- A Singapore company may operate a ‘Supplementary Retirement Scheme (SRS)’ (see below).

A further issue to consider is that accounting for long-term employee benefits is based on accounting for retirement benefits, albeit simplified, thereby requiring you to have some knowledge of the subject.
Section 5 plans are retirement plans established under Section 5 of the Income Tax Act. They were established in 1994 as a way for employers to fund employee retirement savings in addition to CPF. There are various rules applying to these plans, such as all employees must be covered by the plan, the same benefits must apply to all, and only employer contributions (which are tax-deductible) are allowed. There are very few of these plans in existence, and most are defined contribution in nature (see below).

SRSs were introduced in 2001 and allow employees to open a special account in their name at DBS, UOB or OCBC banks. Employers and employees may make contributions, which are tax deductible. Again, these are used rarely in practice and mainly for foreign employees who are not eligible for CPF contributions.

(For more information on Section 5 plans and SRSs, refer to www.actuaries.org.sg/files/library/committee_reports/Employer-Sponsored%20Retirement%20Schemes%2027Jun2013.pdf?download)

Even though you are unlikely to encounter pension plans many times in your career, accounting for them can be complex, and so this chapter provides detailed explanations and illustrations for the requirements of SFRS(I) 1-19.

Types of post-employment benefit plan
There are two types of post-employment benefit plans:

1. Defined contribution
2. Defined benefit

Definitions of these terms are provided within SFRS(I) 1-19.

3.1 Definitions

KEY TERMS

**DEFINED CONTRIBUTION PLANS** are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

**DEFINED BENEFIT PLANS** are post-employment benefit plans other than defined contribution plans.

3.1.1 Defined contribution plans

With defined contribution plans, the employer (and possibly current employees too) pay regular contributions into the plan of a given or ‘defined’ amount each year. The contributions are invested, and the size of the post-employment benefits paid to former employees depends on how well or how badly the plan’s investments perform. If the investments perform well, the plan will be able to afford higher benefits than if the investments performed less well.

3.1.2 Defined benefit plans

With defined benefit plans, the size of the post-employment benefits is determined in advance, ie the benefits are ‘defined’. The employer (and possibly current employees too) pay contributions into the plan, and the contributions are invested. The size of the contributions is set at an amount that is expected to earn enough investment returns to meet the obligation to pay the post-employment benefits. If, however, it becomes apparent that the assets in the fund are insufficient, the employer will be required to make additional contributions into the plan to make up the expected shortfall. On the other hand, if the fund’s assets appear to be larger than they need to be, and in excess of what is required to pay the post-employment benefits, the employer may be allowed to take a ‘contribution holiday’ (ie stop paying in contributions for a while).
SECTION SUMMARY

There are two categories of post-retirement benefits: defined contribution plans and defined benefit plans.

Defined contribution plans provide benefits commensurate with the fund available to produce them.

Defined benefit plans provide promised benefits and so contributions are based on estimates of how the fund will perform.

4 Defined contribution plans: recognition and measurement

SECTION INTRODUCTION

Defined contribution plans are comparatively simple to account for.

A typical defined contribution plan would be where the employing company agreed to contribute an amount of, say, 17% of employees' salaries into a post-employment plan.

4.1 Accounting for a defined contribution plan

Accounting for payments into defined contribution plans is straightforward.

SFRS(I) 1-19 requires the following.

(a) Contributions to a defined contribution plan should be recognised as an expense in the period they are payable (except to the extent that labour costs may be included within the cost of assets).

(b) Any liability for unpaid contributions that are due as at the end of the period should be recognised as a liability (accrued expense).

(c) Any excess contributions paid should be recognised as an asset (prepaid expense), but only to the extent that the prepayment will lead to a reduction in future payments or a cash refund.

In the (unusual) situation where contributions to a defined contribution plan do not fall due entirely within 12 months after the end of the period in which the employees performed the related service, then these should be discounted using the discount rate specified in SFRS(I) 1-19 paragraph 83.

4.2 Disclosure requirements

Entities should disclose the amount recognised as an expense for defined contribution plans.

Where required by SFRS(I) 1-24, entities should disclose information about contributions to defined contribution plans for key management employees.
Example

The Pacific Hotel Corporation Ltd agrees to contribute 5% of employees’ total remuneration into a post-employment defined contribution plan each year. The following information is relevant to the year ended 31 December 20X7:

- Salaries totalled $4.8 million (excluding bonus)
- A bonus was paid to each member of staff equivalent to 10% of their salary
- The company actually paid $250,000 into the plan

What accounting entry is required to recognise the company pension contribution in the year ended 31 December 20X7?

Solution

- Total remuneration is $5.28m (4.8 \times 110%)
- The plan contribution is therefore $264,000 (5.28 \times 5%)

The accounting entry is ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee costs</td>
<td>Cash</td>
<td>264,000</td>
</tr>
<tr>
<td></td>
<td>Accrual</td>
<td>14,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>250,000</td>
</tr>
</tbody>
</table>

State plans

SFRS(I) 1-19 defines state plans as those ‘established by legislation to cover all entities … and operated by national or local government or by another body.’ CPF is therefore an example of a defined contribution state plan.

Following SFRS(I) 1-19, state plans are normally defined contribution plans, therefore CPF contributions should be accounted for in the same way as a defined contribution plan, ie the accounting treatment in the example above.

SECTION SUMMARY

Contributions to a defined contribution plan are recognised as an expense in the period in which they are payable.

5 Defined benefit plans: recognition and measurement

SECTION INTRODUCTION

Accounting for defined benefit plans is more complex and requires the recognition of the plan in the employer’s statement of financial position.

As we have already said, contributions made by a company to a defined benefit plan are variable depending on the plan’s performance. It is therefore not appropriate to account for contributions in the same way as a defined contribution plan as this would result in volatile profits.
Instead, SFRS(I) 1-19 requires that a net defined pension liability (or asset) is shown in the statement of financial position, calculated as:

\[
\text{The present value of the defined benefit obligation} \times \text{The fair value of any plan assets} \times (X) \times (X) \text{Deficit/surplus}
\]

Where the plan is in deficit because the present value of the obligation to pay future benefits to employees exceeds the fair value of plan assets, a liability is recognised in the statement of financial position; in the rare case that a plan is in surplus, an asset is recognised.

It is an actuary's role to calculate the present value of the obligation and the fair value of plan assets in accordance with SFRS(I) 1-19 guidance; the accountant's role is to recognise changes in these amounts from year to year. SFRS(I) 1-19 also provides detailed guidance on this, taking a four step approach, however before we consider this it is important to understand some further definitions.

5.1 Definitions

SFRS(I) 1-19 defines the following key terms to do with the measurement of defined benefit plans in the statement of financial position.

**KEY TERMS**

- **The net defined benefit liability (asset)** is the deficit or surplus.
- **The deficit or surplus** is:
  (a) The present value of the defined benefit obligation less
  (b) The fair value of plan assets (if any).
- **The present value of a defined benefit obligation** is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.
- **Plan assets** comprise:
  (a) Assets held by a long-term employee benefit fund; and
  (b) Qualifying insurance policies. (SFRS(I) 1-19)
- **Fair value** is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date (SFRS(I) 13).

The standard also provides definitions which relate to the change in a defined benefit surplus or deficit (the defined benefit cost):

**Definitions relating to defined benefit cost**

- **Service cost** comprises:
  (a) Current service cost, which is the change in the present value of the defined benefit obligation resulting from employee service in the current period
  (b) Past service cost, which is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment or a curtailment
  (c) Any gain or loss on settlement
- **Net interest on the defined benefit liability (asset)** is the change during the period in the net defined benefit liability (asset) that arises from the passage of time.
Re-measurements of the net defined benefit liability (asset) comprise:

(a) Actuarial gains and losses
(b) The return on plan assets excluding amounts included in net interest on the net defined benefit liability (asset)
(c) Any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset)

**Actuarial gains and losses** are changes in the present value of the defined benefit obligation resulting from:

(a) Experience adjustments (the difference between previous actuarial assumptions and what has actually occurred), and
(b) The effect of changes in actuarial assumptions.

**The return on plan assets** is interest, dividends and other income derived from the plan assets together with realised and unrealised gains or losses on the plan assets less:

(a) Costs of managing plan assets, and
(b) Any tax payable by the plan itself other than tax included in the actuarial assumptions.

**A settlement** is a transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

Now that we have seen the definitions relevant to defined benefit plans, the next sections of the chapter consider SFRS(I) 1-19’s four step approach to accounting for these plans:

<table>
<thead>
<tr>
<th>Step 1: Determine the deficit or surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 2: Determine the amount of net benefit liability/asset</td>
</tr>
<tr>
<td>Step 3: Determine amounts to be recognised in profit or loss</td>
</tr>
<tr>
<td>Step 4: Determine amounts to be recognised in other comprehensive income</td>
</tr>
</tbody>
</table>

### 5.2 Step 1 – determine the deficit or surplus

- The deficit or surplus should be measured with sufficient regularity to ensure that reported amounts are not materially different from the actual value at the reporting date.
- The use of a qualified actuary is not required by SFRS(I) 1-19, however it is encouraged.
- The cost of providing future benefits (the obligation) should be estimated using an actuarial technique, the projected unit credit method. (This method is sometimes referred to as the accrued benefit method pro-rated on service or the benefit/years of service method).
5.2.1 Measure the defined benefit obligation

With the projected unit credit method, it is assumed that each period of service by an employee gives rise to an additional unit of future benefits. The units, each measured separately, build up to the overall obligation.

In order to measure the obligation, an actuary must make a number of assumptions, known as actuarial assumptions. The main categories of actuarial assumptions are as follows.

(a) **Demographic assumptions** are about mortality rates before and after retirement, the rate of employee turnover, early retirement, claim rates under medical plans for former employees, and so on.

(b) **Financial assumptions** include future salary levels (allowing for seniority and promotion as well as inflation) and the future rate of increase in medical costs (not just inflationary cost rises, but also cost rises specific to medical treatments and to medical treatments required given the expectations of longer average life expectancy).

The standard requires actuarial assumptions to be neither too cautious nor too imprudent: they should be ‘unbiased’. They should also be based on ‘market expectations’ at the period-end, over the period during which the obligations will be settled.

5.2.2 Discount to present value

Once measured, the future cost of the defined benefit obligation should be discounted to present value using an appropriate discount rate. The whole obligation is discounted, even if part of it is expected to be settled within 12 months of the end of the reporting period.

Discount rates used should be determined by reference to market yields at the end of the reporting period on high-quality fixed-rate corporate bonds denominated in the same currency as the defined benefit obligation. In their absence, the yields on comparable government bonds denominated in the same currency should be used instead.

5.2.3 Deduct fair value of plan assets

**Plan assets** are deducted from the present value of the defined benefit obligation in order to determine the deficit or surplus. Plan assets are:

(a) Assets such as stocks and shares, held by a fund that is legally separate from the reporting entity, which exists solely to pay employee benefits

(b) Insurance policies, issued by an insurer that is not a related party, the proceeds of which can only be used to pay employee benefits

Investments which may be used for purposes other than to pay employee benefits are not plan assets.

The standard requires that the plan assets are measured at fair value, which is ‘the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date’.

5.3 Step 2 – determine the amount of net benefit liability (asset)

In the statement of financial position, the amount recognised as a defined benefit liability (which may be a negative amount, i.e. an asset) should be the following.

(a) The present value of the defined obligation at the end of the reporting period, minus

(b) The fair value of the assets of the plan as at the end of the reporting period (if there are any) out of which the future obligations to current and past employees will be directly settled.
5.4 Step 3 – determine amounts to be recognised in profit or loss

The change in a net defined pension benefit liability or asset can be attributed to contributions made into the plan, retirement benefits paid out of the plan and three further components which are recognised either in profit or loss or other comprehensive income:

<table>
<thead>
<tr>
<th>Component</th>
<th>Recognised in</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Service costs</td>
<td>Profit or loss</td>
</tr>
<tr>
<td>(b) Net interest on the net defined benefit liability</td>
<td>Profit or loss</td>
</tr>
<tr>
<td>(c) Re-measurements of the net defined benefit liability</td>
<td>Other comprehensive income</td>
</tr>
</tbody>
</table>

5.4.1 Service costs

These comprise:

(a) **Current service cost**, this is the increase in the present value of the defined benefit obligation resulting from employee services during the period

(b) **Past service cost**, which is the change in the obligation relating to service in prior periods. This results from amendments or curtailments to the pension plan

(c) Any gain or loss on settlement

The detail relating to points (b) and (c) above will be covered in a later section.

A current service cost normally arises in each financial year as a result of the fact that most defined benefit pensions provide an incremental benefit for each year of service. This amount increases the plan obligation and is charged as an operating expense in profit or loss.

5.4.2 Net interest on the defined benefit liability (asset)

Net interest is made up of two amounts:

1. The defined benefit obligation is the discounted present value of the future benefits payable. Every year the discount must be 'unwound', increasing the present value of the obligation as time passes through an interest charge.

2. Plan assets are effectively investments, and interest income is earned on these annually.

SFRS(I) 1-19 requires that the interest should be calculated on the net defined benefit liability (asset).

This means that the amount recognised in profit or loss is calculated as the net amount of the interest charge on the obligation and the interest income recognised on the assets.

The calculation is as follows:

\[
\text{Net defined benefit liability/(asset)} \times \text{Discount rate}
\]

(a) The net defined benefit liability/(asset) should be measured as at the start of the accounting period, taking account of changes during the period as a result of contributions paid into the scheme and benefits paid out.

(b) The discount rate adopted should be determined by reference to market yields on high quality fixed-rate corporate bonds. In the absence of a ‘deep’ market in such bonds, the yields on comparable government bonds should be used as reference instead. The maturity of the corporate bonds that are used to determine a discount rate should have a term to maturity that is consistent with the expected maturity of the post-employment benefit obligations.

Where a defined benefit plan is amended, curtailed or settled in a period, the calculation of net interest should reflect this fact (see section 6.1.3).
5.5 Step 4 – determine amounts to be recognised in other comprehensive income

As we saw in the previous section, re-measurements are recognised in other comprehensive income. These comprise:

(a) Actuarial gains and losses
(b) The return on plan assets (excluding amounts included in net interest on the net defined benefit liability/(asset))

The gains and losses relating to points (a) and (b) above will arise in every defined benefit scheme so we will look at these now.

5.5.1 Actuarial gains and losses

At the end of each accounting period, a new valuation, using updated assumptions, should be carried out on the obligation. Actuarial gains or losses are changes in the present value of the defined benefit obligation that arise because of the following.

(a) Actual events (eg employee turnover, salary increases) differ from the actuarial assumptions that were made to calculate the defined benefit obligations which were previously estimated
(b) The effect of changes to assumptions concerning benefit payment options
(c) Estimates are revised (eg different assumptions are made about future employee turnover, salary rises, mortality rates, and so on)
(d) The effect of changes to the discount rate

Actuarial gains and losses are recognised in other comprehensive income. They are not reclassified to profit or loss.

5.5.2 Return on plan assets

A new valuation of the plan assets is carried out at each period end, using current fair values. Any difference between the new value, and what has been recognised up to that date (normally the opening balance, interest, and any cash payments into or out of the plan) is treated as a ‘re-measurement’ and recognised in other comprehensive income.

Example

At 1 January 20X2 the fair value of the assets of a defined benefit plan were valued at $1,100,000 and the present value of the defined benefit obligation was $1,250,000. On 31 December 20X2, the plan received contributions from the employer of $490,000 and paid out benefits of $190,000.

The current service cost for the year was $360,000 and a discount rate of 6% is to be applied to the net liability/(asset).

After these transactions, the fair value of the plan’s assets at 31 December 20X2 was $1.5 million. The present value of the defined benefit obligation was $1,553,600.

Calculate the gains or losses on re-measurement through OCI and the return on plan assets and illustrate how this pension plan will be treated in the statement of profit or loss and other comprehensive income and statement of financial position for the year ended 31 December 20X2.
Solution

It is always useful to set up a working reconciling the assets and obligation:

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Obligation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value/present value at 1/1/X2</td>
<td>$1,100,000</td>
<td>$1,250,000</td>
</tr>
<tr>
<td>Interest (1,100,000 × 6%); (1,250,000 × 6%)</td>
<td>$66,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>Current service cost</td>
<td></td>
<td>$360,000</td>
</tr>
<tr>
<td>Contributions received</td>
<td>$490,000</td>
<td>(190,000)</td>
</tr>
<tr>
<td>Benefits paid</td>
<td>(190,000)</td>
<td>(190,000)</td>
</tr>
<tr>
<td>Return on plan assets excluding amounts in net interest (balancing figure) (OCI)</td>
<td>$34,000</td>
<td>–</td>
</tr>
<tr>
<td>Loss on re-measurement (balancing figure) (OCI)</td>
<td>–</td>
<td>$58,600</td>
</tr>
<tr>
<td></td>
<td>$1,500,000</td>
<td>$1,553,600</td>
</tr>
</tbody>
</table>

The following accounting treatment is required.

(a) In the statement of profit or loss and other comprehensive income, the following amounts will be charged.

In profit or loss:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current service cost</td>
<td>$360,000</td>
</tr>
<tr>
<td>Net interest on net defined benefit liability (75,000 – 66,000)</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

In other comprehensive income (34,000 – 58,600) $24,600

(b) In the statement of financial position, the net defined benefit liability of $53,600 (1,553,600 – 1,500,000) will be recognised.

SECTION SUMMARY

A defined benefit plan is accounted for using a four step process:

1. Determine the deficit or surplus by discounting the obligation to present value and deducting the fair value of plan assets.
2. Determine the net defined benefit liability or asset.
3. Recognise service costs and the net interest on the net defined benefit asset or liability in profit or loss.
4. Recognise re-measurements in other comprehensive income.

6 Defined benefit plans: other matters and current developments

SECTION INTRODUCTION

There may be further complications in accounting for a defined benefit plan where a plan is amended or curtailed.

We have now covered the basics of accounting for defined benefit plans. This section looks at the special circumstances of past service costs, curtailments and settlements.
6.1 Past service costs and gains and losses on settlement

Previously, we identified that the total service cost may comprise not only the current service costs but other items, past service cost and gains and losses on settlement. This section explains these issues and their accounting treatment.

6.1.1 Past service costs

Past service costs represent the change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment.

A plan amendment arises when an entity either introduces a defined benefits plan or changes the benefits payable under an existing plan. As a result, the entity has taken on additional obligations that it has not hitherto provided for. For example, an employer might decide to introduce a medical benefits scheme for former employees. This will create a new defined benefit obligation that has not yet been provided for.

A curtailment occurs when an entity significantly reduces the number of employees covered by a plan. This could result from an isolated event, such as closing a plant, discontinuing an operation or the termination or suspension of a plan.

Past service costs can be either positive (if the changes increase the obligation) or negative (if the change reduces the obligation). They are calculated by measuring the defined benefit liability (or asset) using updated assumptions and comparing benefits offered and plan assets before and after the plan amendment or curtailment, but ignoring the asset ceiling if the plan is in surplus.

Past service costs are recognised in profit or loss at the earlier of the following dates.

(a) When the plan amendment or curtailment occurs, and

(b) When the entity recognises related restructuring costs (in accordance with SFRS(I) 1-37 Provisions, Contingent Liabilities and Contingent Assets) or termination benefits.

6.1.2 Gains and losses on settlement

A settlement occurs either when an employer enters into a transaction to eliminate part or all of its post-employment benefit obligations (other than a payment of benefits to or on behalf of employees under the terms of the plan and included in the actuarial assumptions).

A curtailment and settlement might happen together, for example when an employer brings a defined benefit plan to an end by settling the obligation with a one-off lump sum payment and then scrapping the plan.

The gain or loss on a settlement is the difference between:

(a) The present value of the defined benefit obligation being settled, as valued on the date of the settlement; and

(b) The settlement price, including any plan assets transferred and any payments made by the entity directly in connection with the settlement.

Gains or losses on settlement are recognised immediately in profit or loss when the settlement occurs.

6.1.3 Current service cost and net interest after amendment, curtailment or settlement

In measuring the current service cost and net interest for the remainder of the accounting period after an amendment, curtailment or settlement, an entity should use the updated assumptions from the remeasurement.

Net interest is calculated for the remainder of the accounting period after the amendment by multiplying the net defined benefit liability or asset as remeasured by the discount rate used in the remeasurement.
Example

Prosperity Trading Ltd operated a defined benefit plan under which it provided for retirement benefits at a rate of 1.5% of salary per annum for all employees from the date they joined the company. The obligation and scheme assets were measured as follows.

<table>
<thead>
<tr>
<th>31 October 20X3</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of defined benefit obligation</td>
<td>$31.5m</td>
</tr>
<tr>
<td>Fair value of plan assets</td>
<td>$26m</td>
</tr>
</tbody>
</table>

On 1 November 20X3 the rules of the plan changed to provide for benefit at a rate of 2.5% of salary for employees with over 20 years’ service and the present value of the defined benefit obligation on the new basis was $32.5 million.

Further relevant information is as follows.

- Current service cost was $1.7 million for the period ended 31 October 20X4.
- An overall re-measurement loss of $900,000 was identified.
- Market yields on high quality corporate bonds were 3.5% at 1 November 20X3 and 4.2% at 31 October 20X4.

What should be recognised in profit or loss in respect of the plan in the period ended 31 October 20X4?

Solution

<table>
<thead>
<tr>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current service cost</td>
</tr>
<tr>
<td>Past service cost (32.5m – 31.5m)</td>
</tr>
<tr>
<td>Net interest (3.5% x (31.5 – 26))</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

- Past service cost is the increase in the obligation as a result of the change in plan rules.
- Net interest on the net defined benefit liability is calculated by applying the period-start interest rate to the net liability at the start of the year.

6.2 Employee contributions

In some cases, employees will also make contributions to a retirement benefit plan. SFRS(I) 1-19 clarifies that, where the amount of the contributions is independent of the number of years of service, the contributions should be recognised as a reduction in service cost in the period in which the service is rendered.

Question 14.2

For the sake of simplicity and clarity, all transactions are assumed to occur at the period-end.

The following data applies to the post employment defined benefit compensation plan of BCD Ltd.

Discount rate: 10% (each year)

Present value of obligation at start of 20X2: $1m

Market value of plan assets at start of 20X2: $1m
The following figures are relevant.

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current service cost</td>
<td>140</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>Benefits paid out</td>
<td>120</td>
<td>140</td>
<td>150</td>
</tr>
<tr>
<td>Contributions paid by entity</td>
<td>110</td>
<td>120</td>
<td>120</td>
</tr>
<tr>
<td>Present value of obligation at period-end</td>
<td>1,200</td>
<td>1,650</td>
<td>1,700</td>
</tr>
<tr>
<td>Fair value of plan assets at period-end</td>
<td>1,250</td>
<td>1,450</td>
<td>1,610</td>
</tr>
</tbody>
</table>

Notes:

1. At the end of 20X3, a division of the company was sold. As a result of this, a large number of the employees of that division opted to transfer their accumulated pension entitlement to their new employer's plan. Assets with a fair value of $48,000 were transferred to the other company's plan and the actuary has calculated that the reduction in BCD’s defined benefit liability is $50,000. The period-end valuations in the table above were carried out before this transfer was recorded.

2. At the end of 20X4, a decision was taken to make a one-off additional payment to former employees currently receiving pensions from the plan. This was announced to the former employees before the period-end. This payment was not allowed for in the original terms of the plan. The actuarial valuation of the obligation in the table above includes the additional liability of $40,000 relating to this additional payment.

Required

Show how the reporting entity should account for this defined benefit plan in each of years 20X2, 20X3 and 20X4.

You should work to the nearest $’000.
The types of benefits that might fall into this category include:

(a) Long-term paid absences such as long-service or sabbatical leave
(b) Long-service benefits
(c) Long-term disability benefits
(d) Profit-sharing and bonuses
(e) Deferred remuneration

### 7.2 Accounting treatment for other long-term benefits

There are many similarities between these types of benefits and defined benefit pensions. For example, in a long-term bonus scheme, the employees may provide service over a number of periods to earn their entitlement to a payment at a later date. In some case, the entity may put cash aside, or invest it in some way (perhaps by taking out an insurance policy) to meet the liabilities when they arise.

As there is normally far less uncertainty relating to the measurement of these benefits, SFRS(I) 1-19 requires a simpler method of accounting for them. Unlike the accounting method for post-employment benefits, this method does not recognise re-measurements in other comprehensive income.

The entity should recognise all of the following in **profit or loss**.

(a) **Service cost**
(b) **Net interest** on the defined benefit liability (asset)
(c) **Re-measurement** of the net defined benefit liability (asset)

### Example

(This question has the same basic data as the question in Section 5.5.2. Note how the solution differs to that question when we treat the plan as another long-term employee benefit plan rather than a retirement benefit plan.)

Prosperous Distribution Ltd provides paid sabbatical leave (defined benefits) to employees who have achieved 20 years of service for the company.

At 1 January 20X2 the fair value of the assets of the defined benefit plan were valued at $1,100,000 and the present value of the defined benefit obligation was $1,250,000. On 31 December 20X2, the plan received contributions from the employer of $490,000 and paid out benefits of $190,000.

The current service cost for the year was $360,000 and a discount rate of 6% is to be applied to the net liability/(asset).

After these transactions, the fair value of the plan's assets at 31 December 20X2 was $1.5 million. The present value of the defined benefit obligation was $1,553,600.

Calculate relevant amounts and illustrate how this long-term benefit plan will be treated in the statement of profit or loss and statement of financial position for the year ended 31 December 20X2.

### Solution

It is always useful to set up a working reconciling the assets and obligation:

<table>
<thead>
<tr>
<th></th>
<th>Assets $</th>
<th>Obligation $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value/present value at 1/1/X2</td>
<td>1,100,000</td>
<td>1,250,000</td>
</tr>
<tr>
<td>Interest (1,100,000 × 6%); (1,250,000 × 6%)</td>
<td>66,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Current service cost</td>
<td></td>
<td>360,000</td>
</tr>
<tr>
<td>Contributions received</td>
<td>490,000</td>
<td></td>
</tr>
<tr>
<td>Benefits paid</td>
<td>(190,000)</td>
<td>(190,000)</td>
</tr>
<tr>
<td>Return on plan assets excluding amounts in net interest (balancing figure)</td>
<td>34,000</td>
<td></td>
</tr>
<tr>
<td>Loss on re-measurement (balancing figure)</td>
<td></td>
<td>58,600</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,500,000</td>
<td>1,553,600</td>
</tr>
</tbody>
</table>
The following accounting treatment is required.

(a) In the statement of profit or loss and other comprehensive income, the following amounts will be charged.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current service cost</td>
<td>$360,000</td>
</tr>
<tr>
<td>Net interest on net defined benefit liability (75,000 – 66,000)</td>
<td>$9,000</td>
</tr>
<tr>
<td>Re-measurement of the net defined benefit liability (34,000 – 58,600)</td>
<td>$24,600*</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$393,600</strong></td>
</tr>
</tbody>
</table>

*In Section 5.5.2, when the question was based on a retirement benefit plan, this re-measurement was charged to other comprehensive income rather than profit or loss for the year.

(b) In the statement of financial position, the net defined benefit liability of $53,600 (1,553,600 – 1,500,000) will be recognised.

**SECTION SUMMARY**

All costs in relation to other long-term benefits such as long-term absences are recognised in profit or loss.

8 Termination benefits

**SECTION INTRODUCTION**

Termination benefits are dealt with separately in SFRS(I) 1-19; here the event which gives rise to an obligation is the termination of employment rather than the service of the employee.

Termination benefits are benefits provided in exchange for the termination of an employee's employment. Typically they are lump sum payments (eg redundancy/retrenchment pay) but may also include:

- Enhancement of post-employment benefits
- Salary until the end of a specified notice period

Termination benefits may arise as a result of either:

- An entity's decision to terminate an employee's employment before the normal retirement date (ie compulsory redundancy); or
- An employee's decision to accept an offer of benefits in exchange for the termination of employment (ie voluntary redundancy).

8.1 Recognition and measurement

Termination benefits are accounted for differently from other employee benefits because the event that give rise to such an obligation is the termination of employment rather than rendering of services by employees.
Termination benefits are **recognised** as a liability and an expense at the earlier of:

(a) When the entity can no longer withdraw the offer of termination benefits

(b) When the entity recognises costs for a restructuring that is within the scope of SFRS(I) 1-37 and involves the payment of termination benefits

For termination as a result of an **employee's decision**, the time when the entity can no longer withdraw the offer is the earlier of:

(a) When the employee accepts the offer; and

(b) When a restriction (eg legal, regulatory, or contractual) on the entity's ability to withdraw the offer takes effect. (This would be when the offer is made, if the restriction existed at the time of the offer.)

For termination as a result of an **entity's decision**, the entity can no longer withdraw the offer when the entity has communicated to the affected employees a plan of termination meeting all of the following criteria:

(a) Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made.

(b) The plan identifies the number of employees whose employment is to be terminated, their job classifications or functions and their locations (but the plan need not identify each individual employee) and the expected completion date.

(c) The plan establishes the termination benefits that employees will receive in sufficient detail that employees can determine the type and amount of benefits they will receive when their employment is terminated.

Note that a termination of service may also lead to a **plan amendment or curtailment** of other employee benefits; those employees who are being terminated will no longer accrue service with the entity and so the obligations to those employees and the contributions necessary to settle those obligations will be reduced.

In measuring termination benefits, an entity must take care to **distinguish between** termination benefits (resulting from termination of employment) and enhancement of post-employment benefits (resulting from service). If the termination benefits are an enhancement of post-employment benefits, they are accounted for as such.

Otherwise:

(a) If the termination benefits are expected to be settled wholly before 12 months after the end of the annual reporting period in which the termination benefit is recognised, they are accounted for as short-term employee benefits

(b) If the termination benefits are not expected to be settled wholly before 12 months after the end of the reporting period they are accounted for as other long-term employee benefits

**Example**

As a result of a recent acquisition, Potong Pasir Provisioning Ltd (PPP) plans to close a factory in ten months and, at that time, terminate the employment of all the remaining employees at the factory. Because PPP needs the expertise of the employees at the factory to complete some contracts, it announces a plan of termination as follows:

Each employee who stays and renders service until the closure of the factory will receive on the termination date a cash payment of $30,000. Employees leaving before the closure will each receive $10,000.

There are 120 employees at the factory. At the time of announcing the plan, the entity expects 20 of them to leave before closure.

Explain the correct accounting treatment of the payments to employees.
**Solution**

The total expected cash outflows under the plan are $3.2 million (ie (20 × $10,000) + (100 × $30,000)). PPP should account for benefits provided in exchange for termination of employment as termination benefits and account for benefits provided in exchange for services as short-term employee benefits.

**Termination benefits**

The benefit provided in exchange for termination of employment is $10,000. This is the amount that PPP would have to pay for termination regardless of whether employees stay and render service until the factory closes. PPP recognises a liability of $1.2 million (120 × $10,000) for the termination benefits provided at the earlier of when the plan or termination is announced and when the entity recognises the restructuring costs associated with the closure of the factory.

**Benefits provided in exchange for services**

The incremental benefits that employees will receive if they provide services for the full ten-month period are in exchange for services provided over that period. PPP should account for them as short-term employee benefits because PPP expects to settle them less than 12 months after the period-end. Since this is less than one year, discounting is not required so an expense of $200,000 (ie (($3.2m – $1.2m)/10)) is recognised in each month during the service period of ten months, with a corresponding increase in the carrying amount of the liability.

---

**SECTION SUMMARY**

Termination benefits are recognised as a liability and an expense when an entity is demonstrably committed to provide them.

---

**9 Disclosures**

**SECTION INTRODUCTION**

SFRS(I) 1-19 contains extensive disclosure requirements, particularly in respect of defined benefit plans. Disclosure of employee benefits relating to directors and key management personnel will also be required by the Code of Corporate Governance (Section 9) and by the SGX Rulebooks (Listing Manual, principle 9).

**Short-term benefits**

There are no specific disclosures in respect of short-term benefits, however SFRS(I) 1-19 points out that other standards may require disclosure of these benefits. For example, SFRS(I) 1-24 Related Party Transactions requires disclosure about employee benefits for key management personnel, and SFRS(I) 1-1 Presentation of Financial Statements requires disclosure of employee benefits expense.

**Defined contribution plans**

The amount recognised as an expense in the period should be disclosed.
Defined benefit plans

Disclosures are required which:

(a) Explain the characteristics of its defined benefit plans and risks associated with them;

(b) Identify and explain the amounts in its financial statements arising from its defined benefit plans; and

(c) Describe how defined benefit plans may affect the amount, timing and uncertainty of an entity's future cash flows.

Other long-term benefits and termination benefits

Again, there are no specific SFRS(I) 1-19 requirements here, however other standards may require disclosure of long-term benefits or termination benefits as part of remuneration. For example, SFRS(I) 1-24 Related Party Transactions requires disclosure about employee benefits for key management personnel, and SFRS(I) 1-1 Presentation of Financial Statements requires disclosure of employee benefits expense.

SECTION SUMMARY

SFRS(I) 1-19 disclosure requirements centre on defined benefit plans. Disclosures are required to explain the risks associated with such plans and explain the amounts recognised in relation to them in the financial statements.
Chapter Roundup

**SFRS(I) 1-19**

*Employee Benefits*

- **Short-term benefits**
  - Recognise as:
    - Expense in period employee provides service
    - As a liability if unpaid entitlement at period end

- **Post-employment benefits**
  - Defined contribution or defined benefits
  - Defined contribution plan: recognise contributions as expense and liability if unpaid
  - Defined benefit plan: recognise net defined benefit liability/asset on statement of financial position. Four step approach:
    1. Determine deficit / surplus
    2. Determine net defined benefit liability/asset
    3. Recognise amounts in SPL
    4. Recognise amounts in OCI

- **Other long-term benefits**
  - Recognise as post-employment benefits except all amounts recognised in SPL

- **Termination benefits**
  - Recognise as:
    - Expense
    - Liability
  - Recognise at earlier of:
    - Entity can no longer withdraw offer of benefits
    - Entity recognises restructuring costs (SFRS(I) 1-37)
  - If payable <12m account for as short-term benefit
  - If payable >12m account for as long-term benefit
Quick Quiz

1. What are the four categories of employee benefits covered by SFRS(I) 1-19?
2. What is the difference between defined contribution and defined benefit plans?
3. What is a ‘constructive obligation’ compared to a legal obligation?
4. What amounts in respect of a defined benefit expense should be recognised in profit or loss for the year?
5. What causes actuarial gains or losses?
Answers to Quick Quiz

1. (i) Short-term
(ii) Post-employment
(iii) Other long-term
(iv) Termination

2. A defined contribution plan involves defined amounts being paid into the plan, but with uncertain future benefits; a defined benefit plan involves defined benefits, meaning that contributions may vary.

3. A constructive obligation exists when the entity has no realistic alternative than to pay the amounts as opposed to a requirement in law to pay. Both terms are defined in SFRS(I) 1-37 (see Chapter 12 for more details).

4. Service costs + any gain or loss on settlement + net interest on the net defined liability/asset

5. Gains or losses due to changes in actuarial assumptions.

Answers to Questions

14.1 Sick leave

(a) The fact that the average unused entitlement at 31 December 20X8 is two days is not relevant; SingTravel should base its calculations on the estimated entitlement which it expects to be used in 20X9.

SingTravel expects to pay an additional 12 days of sick pay as a result of the unused entitlement that has accumulated at 31 December 20X8, ie 1½ days \( \times \) 8 employees. The company should recognise a liability equal to 12 days of sick pay. Unless specific employees are expected to be sick, the calculation should be based on average salaries. The amount calculated would be debited to salaries expense and credited to liability.

(b) If the sick leave is non-accumulating, then unused leave at 31 December 20X8 may not be carried forward to 20X9 and so no liability should be recognised.

14.2 Comprehensive

The actuarial gain or loss is established as a balancing figure in the calculations, as follows.

<table>
<thead>
<tr>
<th>Present value of obligation</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>PV of obligation at start of year</td>
<td>$1,000</td>
<td>$1,200</td>
<td>$1,600</td>
</tr>
<tr>
<td>Interest cost (10%)</td>
<td>100</td>
<td>120</td>
<td>160</td>
</tr>
<tr>
<td>Current service cost</td>
<td>140</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>Past service cost</td>
<td></td>
<td></td>
<td>40</td>
</tr>
<tr>
<td>Benefits paid</td>
<td>(120)</td>
<td>(140)</td>
<td>(150)</td>
</tr>
<tr>
<td>Settlements</td>
<td></td>
<td>(50)</td>
<td></td>
</tr>
<tr>
<td>Actuarial (gain)/loss on obligation: balancing figure</td>
<td>80</td>
<td>320</td>
<td>(100)</td>
</tr>
<tr>
<td>PV of obligation at end of year</td>
<td>1,200</td>
<td>1,600</td>
<td><em>(1,650 – 50)</em></td>
</tr>
</tbody>
</table>

\( *(1,650 – 50) \)
**Market value of plan assets**

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Market value of plan assets at start of year</td>
<td>1,000</td>
<td>1,250</td>
<td>1,402</td>
</tr>
<tr>
<td>Interest on plan assets (10%)</td>
<td>100</td>
<td>125</td>
<td>140</td>
</tr>
<tr>
<td>Contributions</td>
<td>110</td>
<td>120</td>
<td>120</td>
</tr>
<tr>
<td>Benefits paid</td>
<td>(120)</td>
<td>(140)</td>
<td>(150)</td>
</tr>
<tr>
<td>Settlements</td>
<td>–</td>
<td>(48)</td>
<td>–</td>
</tr>
<tr>
<td>Gain on re-measurement through OCI: balancing figure</td>
<td>160</td>
<td>95</td>
<td>98</td>
</tr>
<tr>
<td>Market value of plan assets at period-end</td>
<td><strong>1,250</strong></td>
<td><strong>1,402</strong>*</td>
<td><strong>1,610</strong></td>
</tr>
</tbody>
</table>

\*(1,450– 48)

In the statement of financial position, the liability that is recognised is calculated as follows.

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Present value of obligation</td>
<td>1,200</td>
<td>1,600</td>
<td>1,700</td>
</tr>
<tr>
<td>Market value of plan assets</td>
<td>1,250</td>
<td>1,402</td>
<td>1,610</td>
</tr>
<tr>
<td>Liability/(asset) in statement of financial position</td>
<td>(50)</td>
<td>198</td>
<td>90</td>
</tr>
</tbody>
</table>

The following will be recognised in profit or loss for the year.

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Current service cost</td>
<td>140</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>Past service cost</td>
<td>–</td>
<td>–</td>
<td>40</td>
</tr>
<tr>
<td>Net interest on defined benefit liability (asset)</td>
<td>–</td>
<td>(5)</td>
<td>20</td>
</tr>
<tr>
<td>Gain on settlement of defined benefit liability</td>
<td>–</td>
<td>(2)</td>
<td>–</td>
</tr>
<tr>
<td>Expense recognised in profit or loss</td>
<td><strong>140</strong></td>
<td><strong>143</strong></td>
<td><strong>210</strong></td>
</tr>
</tbody>
</table>

The following re-measurements will be recognised in other comprehensive income for the year:

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Actuarial (gain)/loss on obligation</td>
<td>80</td>
<td>320</td>
<td>(100)</td>
</tr>
<tr>
<td>Return on plan assets (excluding amounts in net interest)</td>
<td>(160)</td>
<td>(95)</td>
<td>(98)</td>
</tr>
</tbody>
</table>
This chapter deals with SFRS(I) 2 on share-based payments. Share-based payments in practice are varied and may be complex; they include employee share options and share appreciation rights.
15: Share-based payments | PART D ACCOUNTING FOR ASSETS AND LIABILITIES

Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share-based Payment Transactions and Arrangements</td>
<td>3</td>
</tr>
<tr>
<td>Apply and discuss the recognition and measurement criteria for share-based</td>
<td></td>
</tr>
<tr>
<td>payment transactions and arrangements.</td>
<td></td>
</tr>
<tr>
<td>Account for modifications, cancellations and settlements of share-based</td>
<td>2</td>
</tr>
<tr>
<td>payment transactions and arrangements.</td>
<td></td>
</tr>
<tr>
<td>Emerging Trends</td>
<td>1</td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments.</td>
<td></td>
</tr>
</tbody>
</table>

ESSENTIAL READING

SFRS(I) 2 Share-based Payment, SFRS(I) 2 Illustrative Guidance (IG) and
SFRS(I) INT 19 Extinguishing Financial Liabilities with Equity Instruments

1 Introduction and definitions

SECTION INTRODUCTION

Share-based payments are a contentious area of accounting and are dealt with by SFRS(I) 2 Share-based Payment. There are a number of important definitions which must be learned.

1.1 The need for a standard

Share-based payments are increasingly used by companies to reward employees and directors and pay other parties for goods and services received. These payments may take the form of shares or share options, or sometimes a deferred cash payment measured in relation to the company's share price. Share-based payments are commonly used as a form of consideration by start-up internet companies. This is because such companies are notoriously loss making in the early years of operation and therefore cash poor.

Prior to the issuance of IFRS 2 by the IASB and its subsequent adoption as SFRS(I) 2 by the Singapore ASC in 2017, there was minimal accounting guidance in respect of share-based payments in the older versions of Singapore standard FRS 19. As a result companies granting, for example, share options, tended not to recognise any amounts in the financial statements when the options were granted. The rationale behind this was that share options initially have no value since the exercise price is generally higher than the market price of a share on the date on which the option is granted.

This non-recognition of share-based payments at issue resulted in inconsistencies in how companies reported employee costs: those which paid cash for services provided by employees recognised an expense whilst those which issued share options did not.

The issue of IFRS 2 by the IASB (and its adoption by the ASC as SFRS(I) 2) stopped this inconsistency by requiring that an expense is recognised in relation to share-based payments when they are granted. The creation of significant expenses where previously there were none has the effect of depressing profits, and as a result, this standard remains controversial in practice. It should be noted, however, that the application of the standard is not a matter of choice, and its requirements should be adhered to.
1.2 Objective and scope

SFRS(I) 2 requires an entity to reflect the effects of share-based payment transactions in its profit or loss and financial position.

SFRS(I) 2 applies to all share-based payment transactions. There are three types:

(a) **Equity-settled share-based payment transactions**, in which the entity receives goods or services in exchange for equity instruments of the entity (including shares or share options) or the entity receives goods or services but has no obligation to settle the transaction with the supplier. Such transactions include employee share option schemes and share incentive plans.

(b) **Cash-settled share-based payment transactions**, in which the entity receives goods or services in exchange for amounts of cash that are based on the price (or value) of the entity's shares or other equity instruments of the entity or of another group entity. Examples include share appreciation rights.

(c) Transactions, in which the entity receives or acquires goods or services and either the entity or the supplier has a choice as to whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments

1.2.1 Transactions outside the scope of SFRS(I) 2

Certain transactions are outside the scope of the standard:

(a) Transactions with employees and others in their capacity as a holder of equity instruments of the entity (for example, where an employee receives additional shares in a rights issue to all shareholders)

(b) The issue of equity instruments in exchange for control of another entity in a business combination

(c) Contracts for the purchase of goods to which SFRS(I) 1-32 and or SFRS(I) 9 apply.

1.3 Definitions

SFRS(I) 2 provides a number of definitions related to share-based payments. These are found in the appendix at the end of the standard:
KEY TERMS

SHARE-BASED PAYMENT TRANSACTION A transaction in which the entity:
(a) Receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement; or
(b) Incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.

SHARE-BASED PAYMENT ARRANGEMENT An agreement between the entity (or another group entity) and another party (including an employee) that entitles the other party to receive:
(a) Cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity, or another group entity; or
(b) Equity instruments (including shares or share options) of the entity or another group entity, provided the specified vesting conditions, if any, are met.

EQUITY INSTRUMENT A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

EQUITY INSTRUMENT GRANTED The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.

SHARE OPTION A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

FAIR VALUE The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction. (Note that this definition is different from that in SFRS(I) 13 Fair Value Measurement, but the SFRS(I) 2 definition applies.)

GRANT DATE The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the other party have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the other party (the counterparty) the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

INTRINSIC VALUE The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the other party is (or will be) required to pay for those shares. For example, a share option with an exercise price of $15 on a share with a fair value of $20, has an intrinsic value of $5.

MEASUREMENT DATE The date at which the fair value of the equity instruments granted is measured. For transactions with employees and others providing similar services, the measurement date is the grant date. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.
KEY TERMS

**VEST** To become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets, or equity instruments of the entity vests upon satisfaction of any specified vesting conditions.

**VESTING CONDITION** A condition that determines whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. A vesting condition is either a service condition or a performance condition.

**SERVICE CONDITION** A vesting condition that requires the counterparty to complete a specified period of service during which services are provided to the entity. If the counterparty, regardless of the reason, ceases to provide service during the vesting period, it has failed to satisfy the condition. A service condition does not require a performance target to be met.

**PERFORMANCE CONDITION** A vesting condition that requires:

(a) The counterparty to complete a specified period of service, which can be explicit or implicit

(b) Specified performance targets to be met while the counterparty is rendering the service required in (a)

The period of achieving the performance target(s):

(a) Shall not extend beyond the end of the service period

(b) May start before the service period on the condition that the commencement date of the performance target is not substantially before the commencement of the service period

Performance targets are defined by reference to:

(a) The entity's own operations (or activities) or the operations or activities of another entity in the same group (i.e., a non-market condition); or

(b) The price (or value) of the entity's equity instruments or the equity instruments of another entity in the same group (including shares and share options) (i.e., a market condition).

A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group) such as a division or an individual employee.

**MARKET CONDITION** A performance condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the price (or value) of the entity's equity instruments (or the equity instruments of another entity in the same group), such as:

(a) Attaining a specified share price or a specified amount of intrinsic value of a share option, or

(b) Achieving a specified target that is based on the market price (or value) of the entity's equity instruments (or the equity instruments of another entity in the same group) relative to an index of market prices of equity instruments of other entities.

Market condition requires the counterparty to complete a specified period of service (i.e., a service condition); the service requirement can be explicit or implicit.

**VESTING PERIOD** The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.
Some of these definitions may seem complex, however as we meet them again throughout the chapter, and see examples, their meaning will become clearer.

### SECTION SUMMARY
SFRS(I) 2 ensures that expenses and assets are recognised consistently, whether payment is in the form of cash or a share-based payment such as the granting of share options.

Share-based payments may be equity-settled or cash-settled.

### 2 Recognition and measurement of share-based payments

#### SECTION INTRODUCTION
SFRS(I) 2 provides a basic recognition principle applicable to both equity-settled and cash-settled share-based payments. It also considers how such transactions are measured.

#### 2.1 Recognition: the basic principle
An entity should **recognise goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received**. Goods or services received or acquired in a share-based payment transaction should be recognised as expenses unless they qualify for recognition as assets. For example, services are normally recognised as expenses (because they are normally rendered immediately), while goods that will be consumed over a period of time or sold at a later date are recognised as assets.

If the goods or services were received or acquired in an equity-settled share-based payment transaction the entity should recognise a corresponding increase in equity (reserves).

If the goods or services were received or acquired in a cash-settled share-based payment transaction the entity should recognise a liability.

#### 2.2 Equity-settled share-based payment transactions
Goods or services which are received in an equity-settled share-based payment transaction are recorded by:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense/asset</td>
<td>Equity</td>
</tr>
</tbody>
</table>

To recognise the expense (or asset) and related increase in equity.

Note that the credit to equity is recognised directly in equity and disclosed in the statement of changes in equity.

The issue is how the ‘cost’ of the goods and services received and the equity instruments granted in return is measured.

#### 2.2.1 Measurement
The general principle in SFRS(I) 2 is that when an entity recognises the goods or services received and the corresponding increase in equity, it should measure these at the **fair value of the goods or services received**.
Transactions with parties other than employees
- Where the transaction is with parties other than employees, there is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably.
- If the fair value of the goods or services received cannot be measured reliably, the entity should measure their value by reference to the fair value of the equity instruments granted.
- Where the transaction is with a party other than an employee fair value should be measured at the date the entity obtains the goods or the counterparty renders service.

Transactions with employees
- Where shares, share options or other equity instruments are granted to employees as part of their remuneration package, it is not normally possible to measure directly the services received.
- For this reason, the entity should measure the fair value of the employee services received by reference to the fair value of the equity instruments granted. The fair value of those equity instruments should be measured at the grant date.

Fair value of equity instruments
Where a transaction is measured by reference to the fair value of the equity instruments granted, fair value is based on market prices if available, taking into account the terms and conditions upon which those equity instruments were granted.

If market prices are not available, the entity should estimate the fair value of the equity instruments granted using a valuation technique. (Application of the valuation technique to estimate the fair value of the equity instruments granted is beyond the scope of this exam.)
Example

Balestier Foods grants 300 share options to each of its 500 employees on 1 July 20X1.
The fair value of the share options is $10 on grant date.
How is the share-based transaction measured?

Solution

Equity-settled transactions with employees are measured by reference to the fair value of the equity
instruments granted on the grant date.

Therefore 300 options × 500 employees × $10 = $1.5 million.

2.2.2 Recognition: immediate vesting

When equity instruments are granted they may vest immediately, in other words the recipient is entitled
to them immediately. This is normally the case where the share-based transaction is with a party other
than an employee. In this case the transaction is recognised in full on the grant date.

Example

Orchard Trading obtains goods from a supplier on 1 November 20X2, issuing new equity instruments as
payment. The goods supplied by Punggol Supplies have a fair value of $7,000 and the equity instruments
have a market value of $6,700 on the transaction date. The equity instruments vest immediately.

Orchard Trading measures the transaction at $7,000, being the fair value of the goods supplied, and
recognises this amount immediately by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases</td>
<td>Equity</td>
</tr>
<tr>
<td>7,000</td>
<td>7,000</td>
</tr>
</tbody>
</table>

To record the equity-settled share-based payment transaction with the supplier.

2.2.3 Recognition: vesting period

In some cases equity instruments granted will not vest until specified conditions have been met. These
conditions are normally required to be met over a certain period, known as a vesting period. There are
many complications associated with vesting conditions and grant dates. One example is options granted
to employees where there is a possibility of an initial public offering (IPO) of the company.

Recognition of the share-based payment transaction is spread over the vesting period. For example, the
employee is not entitled to the options (ie they do not vest) until a specified period of service has been
completed. If an employee is granted share options on condition that he or she completes three years' service,
then the services to be rendered by the employee as consideration for the share options will be
received over that three-year vesting period. Therefore, the corresponding expense should be recognised
over the same period.

Vesting period

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grant date</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>+ expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>+ expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>= Total expense</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Example

Balestier Foods grants 300 share options to each of its 500 employees on 1 July 20X1.

The fair value of the share options is $10 on grant date. These options vest on 1 July 20X3 conditional upon two years of continued service until that date. No employees are expected to leave the company within the next two years.

How is the share-based transaction recognised in Balestier Foods’ financial statements in the years ended 30 June 20X2 and 20X3?

Solution

The transaction is measured at $1.5 million (300 options × 500 employees × $10)

This amount is recognised equally in each of the two accounting periods until the vesting date. The journal required to record the transaction in both years is ($’000):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee costs</td>
<td>Equity</td>
</tr>
<tr>
<td>750</td>
<td>750</td>
</tr>
</tbody>
</table>

to recognise share options granted to employees

Amounts reported in the financial statements are therefore:

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>$'000</td>
<td>$'000</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>750</td>
<td>1,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of profit or loss</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee costs</td>
<td>750</td>
</tr>
</tbody>
</table>

In the above example, it is assumed that all employees will continue to be employed throughout the vesting period and therefore all share options will vest. This is generally not the case. SFRS(I) 2 requires that measurement of an equity-settled share-based payment transaction is based on the best available estimate of the number of equity instruments expected to vest. An entity should revise that estimate if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity should revise the estimate to equal the number of equity instruments that actually vest.

Once the goods and services received and the corresponding increase in equity has been recognised, the entity should make no subsequent adjustment to total equity after the vesting date.

Example

Balestier Foods issues 300 share options to each of its 500 employees on 1 July 20X1.

The fair value of the share options is $10 on grant date. These options vest after two years of continued service on 1 July 20X3. During the year ended 30 June 20X2 ten employees left and it is expected that a further five will leave in the next year. During the year ended 30 June 20X3 a further eight actually left the company.

How is the share-based transaction recognised in Balestier Foods’ financial statements in the years ended 30 June 20X2 and 20X3?

Solution

At 30 June 20X2 the total transaction is measured based on the number of options expected to vest at $1,455,000 (300 options × (500 – 10 – 5) employees × $10).
As the vesting period is two years, half of this amount is recognised in the year ended 30 June 20X2 ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee costs</td>
<td>Equity 727,500</td>
</tr>
</tbody>
</table>

727,500 to recognise share options granted to employees

At 30 June 20X3 the total transaction is re-measured based on the number of options which will vest at $1,446,000 (300 options × (500 – 10 – 8) employees × $10).

$727,500 was recognised in the year ended 30 June 20X2, and therefore a further $718,500 (1,446,000 – 727,500) is recognised in the second year of the vesting period ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee costs</td>
<td>Equity 718,500</td>
</tr>
</tbody>
</table>

718,500 to recognise share options granted to employees

Amounts reported in the financial statements are therefore:

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>$000</td>
<td>$000</td>
</tr>
<tr>
<td>727.5</td>
<td>1,446</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of profit or loss</th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee costs</td>
<td>727.5</td>
<td>718.5</td>
</tr>
</tbody>
</table>

**Question 15.1**

On 1 January 20X1 an entity grants 100 share options to each of its 400 employees. Each grant is conditional upon the employee working for the entity until 31 December 20X3. The fair value of each share option is $20.

During 20X1 20 employees leave and the entity estimates that 20% of the original employees will leave in total during the three-year period.

During 20X2 a further 25 employees leave and the entity now estimates that 25% of the original employees will leave in total during the three-year period.

During 20X3 a further ten employees leave.

Required

Calculate the remuneration expense that will be recognised in respect of the share-based payment transaction for each of the three years ended 31 December 20X1, 20X2 and 20X3.

**Question 15.2**

On 1 January 20X3 an entity grants 250 share options to each of its 200 employees. The only condition attached to the grant is that the employees should continue to work for the entity until 31 December 20X6. Five employees leave during 20X3. Another 15 employees are expected to leave over the next 3 years.

The market price of each option was $12 at 1 January 20X3 and $15 at 31 December 20X3.

Required

Show how this transaction will be reflected in the financial statements for the year ended 31 December 20X3.
2.2.4 Multiple vesting dates

In the share-based payment schemes seen in the above examples, there is one date on which the share options vest. It may, however, be the case that there are a number of vesting dates within one scheme. In this case, the options relating to each vesting date should be accounted for separately.

**Example**

On 1 March 20X5, Somerset Imports Ltd granted 6,000 options to each of the three directors of the company. Half of these vest on 28 February 20X7 and half on 28 February 20X8 on the condition that the directors continue to be employed by Somerset Imports Ltd on the relevant vesting date.

It was expected that all of the directors would continue to be employed to 28 February 20X7. However on 31 October 20X6, one of them left the company. This departure did not alter expectations with regards to the remaining directors continuing in employment.

On 1 March 20X5, the fair value of each option was estimated to be $30.

Show the accounting treatment in each of the years ended 28 February 20X7, 20X8 and 20X9.

**Solution**

Options vesting in 20X7

<table>
<thead>
<tr>
<th>Date</th>
<th>Options</th>
<th>Directors</th>
<th>Fair Value</th>
<th>Total $</th>
</tr>
</thead>
<tbody>
<tr>
<td>28 February 20X6</td>
<td>3,000</td>
<td>3</td>
<td>$30</td>
<td>$270,000</td>
</tr>
<tr>
<td>28 February 20X7</td>
<td>3,000</td>
<td>2</td>
<td>$30</td>
<td>$180,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$135,000</td>
</tr>
</tbody>
</table>

Options vesting in 20X8

<table>
<thead>
<tr>
<th>Date</th>
<th>Options</th>
<th>Directors</th>
<th>Fair Value</th>
<th>Total $</th>
</tr>
</thead>
<tbody>
<tr>
<td>28 February 20X6</td>
<td>3,000</td>
<td>3</td>
<td>$30</td>
<td>$270,000</td>
</tr>
<tr>
<td>28 February 20X7</td>
<td>3,000</td>
<td>2</td>
<td>$30</td>
<td>$180,000</td>
</tr>
<tr>
<td>28 February 20X8</td>
<td>3,000</td>
<td>2</td>
<td>$30</td>
<td>$180,000</td>
</tr>
</tbody>
</table>

Accounting entries are required as follows ($):

**28 February 20X6**

DEBIT | Directors' remuneration 225,000
CREDIT | Equity 225,000

to record the equity-settled share-based payment in 20X6

**28 February 20X7**

DEBIT | Directors' remuneration 75,000
CREDIT | Equity 75,000

to record the equity-settled share-based payment in 20X7

**28 February 20X8**

DEBIT | Directors' remuneration 60,000
CREDIT | Equity 60,000

to record the equity-settled share-based payment in 20X8
2.3 Cash-settled share-based payment transactions

Some transactions are 'share based', even though they do not involve the issue of shares, share options or any other form of equity instruments. Examples of this type of transaction include:

(a) **Share appreciation rights** granted to employees: the employees become entitled to a future cash payment (rather than an equity instrument), based on the increase in the entity's share price from a specified level over a specified period of time; or

(b) An entity might grant to its employees a right to receive a future cash payment equal to the entity's share price. This may be referred to as a 'phantom share plan'.

Goods or services which are received in a cash-settled share-based payment transaction are recorded by:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Expense/asset</th>
<th>X</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Liability</td>
<td>X</td>
</tr>
</tbody>
</table>

to recognise the expense (or asset) and related liability

Again, we must consider how the transaction is measured and recognised.

2.3.1 Measurement

The basic principle is that the entity measures the goods or services acquired and the liability incurred at the **fair value of the liability**.

The entity should **re-measure** the fair value of the liability **at each reporting date** until the liability is settled **and at the date of settlement**. Any changes in fair value are recognised in **profit or loss** for the period.

2.3.2 Recognition

The entity should recognise the services received, and a liability to pay for those services, **as the employees render service**. For example, if share appreciation rights do not vest until the employees have completed a specified period of service, the entity should recognise the services received and the related liability, over that period.

**Example**

On 1 January 20X1 an entity grants 100 cash share appreciation rights (SARs) to each of its 500 employees, on condition that the employees continue to work for the entity until 31 December 20X3. Cash is payable at the end of the three years based on the share price on 1 January 20X4.

During 20X1, 35 employees leave. The entity estimates that a further 60 will leave during 20X2 and 20X3.

During 20X2, 40 employees leave and the entity estimates that a further 25 will leave during 20X3.

During 20X3, 22 employees leave.

The fair values of the SARs for each year in which a liability exists are shown below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>31.12.20X1</td>
<td>14.40</td>
</tr>
<tr>
<td>31.12.20X2</td>
<td>15.50</td>
</tr>
<tr>
<td>31.12.20X3</td>
<td>18.20</td>
</tr>
</tbody>
</table>

Calculate the amount to be recognised in profit or loss for each of the three years ended 31 December 20X3 and the liability to be recognised in the statement of financial position at 31 December for each of the three years.
**Solution**

For the three years to the vesting date of 31 December 20X3 the expense is based on the entity's estimate of the number of SARs that will actually vest (as for an equity-settled transaction). However, the fair value of the liability is **re-measured** at each year-end.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Liability at year-end</th>
<th>Expense for year</th>
</tr>
</thead>
<tbody>
<tr>
<td>31.12.X1</td>
<td>Expected to vest (500 – 95):</td>
<td>$194,400</td>
<td>$194,400</td>
</tr>
<tr>
<td></td>
<td>405 employees × 100 × $14.40 × 1/3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31.12.X2</td>
<td>Expected to vest (500 – 100):</td>
<td>$413,333</td>
<td>$218,933</td>
</tr>
<tr>
<td></td>
<td>400 employees × 100 × $15.50 × 2/3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31.12.X3</td>
<td>Expected to vest (500 – 97)</td>
<td>$733,460</td>
<td>$320,127</td>
</tr>
<tr>
<td></td>
<td>403 employees × 100 × $18.20</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Question 15.3**  
**Share-based payment 3**

Lucky Catering Co (LCC) granted 200 options on its ordinary shares to each of its 800 employees on 1 January 20X1. Each grant is conditional upon the employee being employed by LCC until 31 December 20X3.

LCC estimated at 1 January 20X1 that:

(a) The fair value of each option was $4 (before adjustment for the possibility of forfeiture).

(b) Approximately 50 employees would leave during 20X1, 40 during 20X2 and 30 during 20X3 thereby forfeiting their right to exercise the options. The departures were expected to be evenly spread within each year.

The exercise price of the options was $1.50 and the market value of an LCC share on 1 January 20X1 was $3.

In the event, only 40 employees left during 20X1 (and the estimate of total departures was revised down to 95 at 31 December 20X1), 20 employees left during 20X2 (and the estimate of total departures was revised to 70 at 31 December 20X2) and none during 20X3, spread evenly during each year.

**Required**

The directors of LCC have asked you to illustrate how the scheme is accounted for under **SFRS(I) 2 Share-based Payment**.

(a) Show the double entries for the charge to profit or loss for employee services over the three years and for the share option issue, assuming all employees entitled to benefit from the scheme exercised their rights and the shares were issued on 31 December 20X3.

(b) Explain how your solution would differ had LCC offered its employees cash based on the share value rather than share options.
2.4 Share-based payments with choice of settlement

Accounting for share-based transactions with a choice of settlement depends on which party has the choice.

2.4.1 Counterparty has choice

Where the counterparty has a choice of settlement, the entity is deemed to have granted a compound instrument, and a liability component and an equity component are identified.

Where the transaction is with parties other than employees and the fair value of the goods or services received is measured directly, the entity shall measure the equity component of the compound financial instrument as the difference between the fair value of the goods or services received and the fair value of the debt component, at the date when the goods or services are received.

For all other transactions, including those with employees, the fair value of the compound instrument is estimated as a whole. The debt and equity components are then valued separately.

Normally transactions are structured in such a way that the fair value of each alternative settlement is the same.

The entity is required to account separately for the goods or services received or acquired in respect of each component of the compound financial instrument. The debt component is accounted for in the same way as a cash-settled share-based payment. The equity component is recognised in the same way as an equity-settled share-based payment.

Example

On 1 January 20X1 an entity grants an employee 1,000 share options under which she can, if she is still employed on 31 December 20X3, elect to receive either 1,000 shares, at a cost of $15 each, or cash to the value, on that date, of 1,000 shares, less $10 per share. The fair value of an option at the grant date (ignoring the cash alternative) was $12.

The market price of the entity's shares is:
- $15 at the date of grant
- $19 at the end of 20X1
- $22 at the end of 20X2
- $25 at the end of 20X3

Calculate amounts to be recognised in profit or loss and as equity and a liability in each year of the vesting period and state how the exercise of the options is accounted for if the employee:

(a) Elects to receive the cash
(b) Selects to receive the shares

Solution

This arrangement results in a compound financial instrument.

The fair value of the cash alternative is:

\[ 1,000 \times ($15 - $10) = $5,000 \]

The fair value of the equity instrument at the grant date is:

\[ 1,000 \times $12 = $12,000 \]

The fair value of the equity component is therefore:

$7,000 ($12,000 less $5,000)
### 2.4.2 Entity has choice

Where the entity has a choice of settlement, the whole transaction is treated either as cash-settled or as equity-settled, depending on whether the entity has an obligation to settle in cash. It may be determined that there is an obligation to settle in cash if an entity is legally prohibited from issuing shares or it has a past practice of settling in cash.

If the entity has incurred a liability to settle in cash or other assets it should account for the transaction as a cash-settled share-based payment transaction.

If no such liability has been incurred the entity should account for the transaction as an equity-settled share-based payment transaction.

### 2.4.3 Net settlement features

In some jurisdictions, when an employee is awarded share-based payments, these are taxed and the awarding entity is required to withhold the relevant tax amount and transfer it to the authorities, in the form of cash.

The terms of the employee share-based payment arrangement may allow or require the entity to meet this obligation by deducting equity instruments that would otherwise be issued to the employee on exercise or vesting of a share-based payment. This is a net settlement feature.

SFRS(I) 2 clarifies that where there is a net settlement feature, this is not a compound instrument (ie this does not constitute a choice of settlement on the employee's part) and the transaction is classified as equity-settled in its entirety providing that it would have been classified as such had the net settlement feature not existed.

### Example

On 1 January 20X1 Bolam Botanics Limited (BBL) grants an employee 500 shares, conditional upon four years of continued service from that date. The terms of the arrangement require that BBL withholds the number of shares with a fair value equal to the monetary value of the employee's tax arising on the transaction, and issues the remaining shares to the employee on the vesting date. The fair value of each option at the grant date is $5 and the fair value at the vesting date is $9. The employee is liable for tax at 40% of the fair value of the shares on the vesting date.

What journal entries are required by BBL in the years ended 31 December 20X1 to 20X4 in respect of the arrangement, assuming that the employee remains in BBL's employment?

<table>
<thead>
<tr>
<th>Year</th>
<th>Liability ($)</th>
<th>Equity ($)</th>
<th>Expense ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$3,000 × ($19 – $10)</td>
<td>7,000 × 1/3</td>
<td>3,000 × 1/3</td>
</tr>
<tr>
<td>20X2</td>
<td>$8,000 × ($22 – $10)</td>
<td>7,000 × 2/3</td>
<td>5,000 × 2/3</td>
</tr>
<tr>
<td>20X3</td>
<td>$15,000 × ($25 – $10)</td>
<td>7,000</td>
<td>7,000 × 1/3</td>
</tr>
</tbody>
</table>

(a) If the employee elects to receive cash rather than shares, the $15,000 liability is reduced to nil and the equity component remains at $7,000.

(b) If the employee elects to receive shares rather than cash, the liability is re-classified to equity. Note that in this case, the employee is likely to elect the cash option because the proceeds of $1,000 × ($25 – $10) = $15,000 is higher than the equity option ie $1,000 × ($25 – $15) = $10,000.
Solution

The journal entries throughout the vesting period are unaffected by the net settlement feature. In each of the four years ended 31 December 20X4, an expense of $625 (500 × $5 × ¼) is recognised by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Staff costs</td>
<td>Equity</td>
<td>625</td>
</tr>
</tbody>
</table>

Therefore at the vesting date (31 December 20X4) there is an equity balance of $2,500.

The fair value of the shares on the vesting date is $4,500 (500 × $9). Therefore tax arises of $1,800 (equivalent to 200 shares at fair value). To reflect this, on vesting BBL issues 300 shares to the employee and withholds 200 shares to settle the tax. Therefore the settlement of tax is recognised by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity (2,500 × 200/500)</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Expense</td>
<td>Liability</td>
<td>1,000</td>
</tr>
<tr>
<td>Liability</td>
<td>Cash</td>
<td>1,800</td>
</tr>
</tbody>
</table>

SECTION SUMMARY

An entity should recognise goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received.

Equity-settled share-based payments are measured at the fair value of goods or services received, or in the case of transactions with employees at the fair value of the equity instruments granted and recorded by:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense/asset</td>
<td>Equity</td>
<td>X</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

In the case of cash-settled share-based payment transactions, the entity should re-measure the fair value of the liability at each reporting date until the liability is settled and at the date of settlement.

Cash-settled share-based payments are measured at the fair value of the liability and recorded by:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense/asset</td>
<td>Liability</td>
<td>X</td>
</tr>
<tr>
<td>Liability</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

Share-based payment transactions are recognised over the vesting period or immediately if there is no vesting period.

Accounting for share-based transactions with a choice of settlement depends on which party has the choice.

3 Share-based payment transactions: further issues

SECTION INTRODUCTION

You should be aware of the impact of different types of vesting conditions and modifications including cancellations and settlements.
3.1 Vesting conditions

As we have seen, to 'vest' is to become an entitlement; a counterparty's right to receive cash, other assets or equity instruments of an entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions.

A vesting condition may be either a service condition or a performance condition.

3.1.1 Service conditions

A service condition is defined by the standard as a vesting condition that requires the counterparty to complete a specified period of service during which services are provided to the entity. It does not require any performance target to be met.

3.1.2 Performance conditions

A performance condition is defined by the standard as a vesting condition that requires:

(a) The counterparty to complete a specified period of service
(b) Specified performance targets to be met while the counterparty is rendering service (the performance target may not extend beyond the related service period)

Performance targets may be defined by reference to:

- The operations or activities of the entity (or another entity in the same group); or
- The price of the equity instruments of the entity (or another entity in the same group).

SFRS(I) 2 also clarifies that a performance target can relate to an entity as a whole or to a part of it, eg a division or an individual employee.

Performance targets which are related to the operations or activities of an entity (or entity in the same group) are referred to as non-market conditions; performance targets which are related to the price of the equity instruments of the entity (or another entity in the same group) are referred to as market conditions.

### Non-market conditions

- Achievement of minimum sales or earnings target
- Achievement of a specific increase in profit or earnings per share
- Completion of a particular project

### Market conditions

Performance conditions that are related to the market price/value of the equity instruments of the entity or another entity in the same group, eg:

- Attaining a specified share-price or specified amount of intrinsic value of a share option; or
- Achieving a specified target that is based on the market price (or value) of the equity instruments of the entity (or another entity in the same group) relative to an index of market prices of equity instruments in other entities.
3.1.3 Treatment of vesting conditions

SFRS(I) 2 provides guidance on the treatment of vesting conditions when accounting for share-based payment transactions:

(a) Service conditions and non-market performance conditions are taken into account by adjusting the number of awards (equity instruments or cash rights) included in the measurement of a share-based transaction. They are not incorporated into the fair value of the equity instrument/rights granted at the grant date. We have seen this in previous examples where we have adjusted for the number of options or rights not expected to vest as the result of an employee leaving a company.

(b) Market based performance conditions are taken into account when estimating the fair value of shares, share options or rights at the measurement date (being grant date for equity-settled share-based payments or each reporting date for cash-settled share-based payments). Therefore these are not taken into account when estimating whether awards will vest.

Note that vesting conditions are treated in the same way for both equity-settled and cash-settled share-based payments.

Example

On 1 July 20X8 an entity granted options over 50,000 of its shares to Becky, one of its senior employees. One of the conditions of the share option scheme was that Becky must work for the entity for two years. Becky continued to be employed by the entity during 20X9 and 20Y0. A second condition for vesting is that the share price increases at 18% per annum compound over the two-year period. At the date of grant the fair value of each share option was estimated at $48 taking into account the estimated probability that the necessary share price growth would be achieved at 18%.

For the two years to 30 June 20Y0 the increase in share price was 17% per annum compound.

How should the transaction be recognised?

Solution

Becky satisfied the service requirement but the share price growth condition was not met. The share price growth is a market condition and is taken into account in estimating the fair value of the options at grant date. No adjustment should be made if there are changes from that estimated in relation to the market condition. There is no write-back of expenses previously charged, even though the share options do not vest.

The expense recognised in profit or loss in each of the two years is \( \frac{1}{2} \times 50,000 \times 48 = 1,200,000 \). This is recognised each year by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee costs</td>
<td>Equity</td>
</tr>
<tr>
<td>1,200,000</td>
<td>1,200,000</td>
</tr>
</tbody>
</table>
3.2 Modifications to equity-settled share-based payments

An entity might modify the terms and conditions on which equity instruments are granted. For example, the exercise price of options may be reduced, so increasing the fair value of the options or the company may change options into cash settled instruments to increase liquidity of the instruments to employees.

The SFRS(I) 2 requirements in respect of modifications apply to all share-based payment transactions that are measured by reference to the fair value of the equity instruments granted.

3.2.1 Measurement of modifications

Where a modification increases the fair value of the equity instruments granted, the incremental fair value should be included in the measurement of the amount recognised for the services received over the remainder of the vesting period.

The incremental fair value is the difference between the fair value of the modified equity instrument and that of the original equity instrument. Both values are estimated as at the modification date.

A modification may

- **Increase** the total fair value of the share-based payment arrangement eg:
  - Number of instruments granted is increased
  - Exercise price is decreased
  - Vesting conditions are removed or reduced

- **Decrease** the total fair value of the share-based payment arrangement eg:
  - Number of instruments granted is reduced
  - Exercise price is increased
  - Vesting conditions are modified in a way that is not beneficial to the employee

Continue to recognise the **original expense** based on the grant date fair value of the equity instruments (unless a service or non-market performance condition means the instruments do not vest)

**PLUS**

For the remainder of the vesting period recognise the effect of the modifications. If the modification arises after the vesting period, recognise immediately.

Example

Pioneer Plant Ltd issued 200 share options to 400 employees on 1 January 20X4 when the fair value of each option was $18. These vest on 31 December 20X6, assuming that employees remain in the service of the company. In the year ended 31 December 20X4, 42 employees left the company and it was expected that a further 73 would leave in the following 2 years. In the year ended 31 December 20X5, 36 employees left and it was expected that a further 29 would leave in the following year. In the year ended 31 December 20X6, 27 employees left.
On 31 December 20X4, in response to a fall in the share price, the exercise price of the options was amended to $7 rather than $9. As a result, the difference between the fair value of the modified share option and that of the original on the modification date is $3.

What amount is recognised as an expense in each year of the scheme and what is the balance on the relevant equity account at 31 December 20X6 prior to the exercise of any options?

**Solution**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Based on original exercise price</td>
<td>$342,000</td>
<td>$361,200</td>
<td>$358,800</td>
</tr>
<tr>
<td>$200 × (400 – 42 – 73) × $18/3 years</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$342,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>[200 × (400 – 42 – 73) × $18 × 2/3] –</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$342,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$87,900</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Addition expense due to modification**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$200 × (400 – 42 – 36 – 29) × $3/2 years</td>
<td>$87,900</td>
<td>$89,100</td>
<td>$89,100</td>
</tr>
<tr>
<td>$87,900</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The balance in equity at 31 December 20X6 is $1,239,000 (342,000 + 449,100 + 447,900).

### 3.2.2 Cancellations and settlements

If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) The entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore **recognise immediately** the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

(b) Any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the **repurchase of an equity interest**, i.e., as a deduction from equity, except to the extent that the payment **exceeds the fair value** of the equity instruments granted measured at the repurchase date.

This is best understood by way of an example:

**Example**

Queenstown Manufacturing Ltd granted 1,000 share options to each of its ten managers on 1 June 20X6. The options only vest if the managers are still employed by the entity on 31 May 20X9.

The fair value of the options was estimated at $20 on the grant date and the entity estimated that the options would vest with seven managers. The entity cancelled the existing share option scheme on 31 May 20X8 when the fair value of the options was $32 and the market price of the entity's shares was $53.

Compensation was paid to the eight managers in employment at that date, at the rate of $41 per option.

How should the entity recognise the cancellation?
Solution

- The original cost to the entity for the share option scheme was:
  1,000 shares × 7 managers × $20 = $140,000
- This was being recognised at the rate of $46,667 in each of the three years.
- At 31 May 20X8 the entity should recognise a cost based on the amount of options it had vested on that date. The total cost is calculated based on the actual amount paid to eight managers:
  1,000 × 8 managers × $20 = $160,000
- After deducting the amount recognised in the year ended 31 May 20X7, the 20X8 charge to profit or loss is $113,333 ($160,000 − 46,667).
- The compensation paid is:
  1,000 × 8 × $41 = $328,000
- Of this, the amount attributable to the fair value of the options cancelled is:
  1,000 × 8 × $32 (the fair value of the option, not of the underlying share) = $256,000
- This is deducted from equity as a share buyback. The remaining $72,000 ($328,000 less $256,000) is charged to profit or loss.
- The journal to record this is:
  DEBIT  Equity  $256,000
  DEBIT  Profit or loss  $72,000
  CREDIT  Cash  $328,000

An equity-settled share-based payment may be reclassified as cash-settled, for example because an entity has changed its settlement practice or is de-listing.

SFRS(I) 2 provides no explicit guidance on this situation, however by analogy with SFRS(I) 2 para. 29 the following treatment should be applied:

- A liability is recognised, measured at the modification date fair value of the equity-settled award based on the elapsed portion of the vesting period.
- The equity balance is derecognised.

Subsequently the liability is remeasured at each subsequent reporting date and increases to the liability are recognised as an expense.

3.3 Modifications to cash-settled share-payment transactions

SFRS(I) 2 clarifies the accounting for two situations:

1. Modifications to the terms and conditions of a share-based payment transaction that result in it changing from a cash-settled to an equity-settled transaction.
2. Transactions in which a cash-settled share-based payment is settled and replaced by a new equity-settled share-based transaction.

In both cases:

- The liability recognised in respect of the original cash-settled share-based transaction is derecognised on modification.
- The equity-settled share-based payment transaction is measured by reference to the modification date fair value of the equity instruments granted as a result of the modification.
- The equity-settled share-based transaction is recognised to the extent that services have been rendered up to the modification date.
- The difference between the carrying amount of the liability derecognised and the amount recognised in equity at the same date is recognised in profit or loss immediately.
Example

Kingsway Properties Ltd (KPL) granted 100 share appreciation rights (SARs) to each of its 50 managers on 1 January 20X2. The options only vest if the managers are still employed by KPL on 31 December 20X4. At 31 December 20X2 the fair value of each SAR was $15; on 31 December 20X3 the fair value of each SAR was $21. On 31 December 20X3, KPL cancelled the SARs and granted 100 share options to each of the 50 managers (all of whom remained employed by the company). On this date the fair value of a share option was $22.50.

How should the entity recognise the share-based payment transaction over the vesting period, assuming that no managers leave KPL before the vesting date?

Solution

- In the year ended 31 December 20X2, an expense of $25,000 \((100 \times 50 \times \$15 \times \frac{1}{3}\text{years})\) is recognised by ($):
  - DEBIT Staff costs  25,000
  - CREDIT Liability  25,000

- In the year ended 31 December 20X3, an expense of $45,000 \(((100 \times 50 \times \$21 \times \frac{2}{3}\text{years}) – \$25,000)\) is recognised by ($):
  - DEBIT Staff costs  45,000
  - CREDIT Liability  45,000

- Therefore at the date of the modification the liability has a carrying amount of $70,000 \((25,000 + 45,000)\).

- On 31 December 20X3, the fair value of the equity-settled scheme is $75,000 \((100 \times 50 \times \$22.50 \times \frac{2}{3}\text{years})\). Therefore to derecognise the liability and recognise the equity balance ($):
  - DEBIT Liability  70,000
  - DEBIT Staff costs  5,000
  - CREDIT Equity  75,000

- In the year ended 31 December 20X4, an expense of $37,500 \(((100 \times 50 \times \$22.50) – \$75,000)\) is recognised by ($):
  - DEBIT Staff costs  37,500
  - CREDIT Equity  37,500

3.4 Related Interpretation

SFRS(I) INT 19 *Extinguishing Financial Liabilities with Equity Instruments* is related to SFRS(I) 2 and deals with the situation where an entity issues equity instruments in order to extinguish a liability due to another entity. This is sometimes known as a debt for equity swap.

In particular SFRS(I) INT 19 addresses the issues of:

1. Whether consideration in the form of equity instruments extinguishes a financial liability
2. How the issuing entity should initially measure these equity instruments
3. How the issuing entity should account for any difference between the carrying amount of the liability and the equity instruments issued
3.4.1 Extinguishing a liability
The issue of instruments should be treated as consideration to extinguish financial liabilities, and the financial liability should be derecognised provided that the relevant criteria contained within SFRS(I) 9 are met (see Chapter 16).

3.4.2 Measurement and recognition of equity instruments
The equity instruments are measured at the fair value of the issued equity instruments (if their fair value can be measured reliably).
If fair value cannot be measured reliably, the equity instruments are measured to reflect the fair value of the financial liability extinguished.
The equity instruments are initially recognised at the date on which the financial liability is extinguished.

3.4.3 Difference between carrying amount of liability and equity instruments
The difference between the carrying amount of the financial liability extinguished and the consideration paid is recognised in profit or loss.

SECTION SUMMARY
Vesting conditions may be service or performance conditions. Performance conditions may be market or non-market conditions. Service conditions and non-market performance conditions are taken into account when considering the number of awards that will vest; market performance conditions are taken into account when calculating the fair value of an award at the measurement date.
A cancellation or settlement is accounted for as an acceleration of the vesting period. Any payment made to the employee on the cancellation or settlement of the grant is accounted for as the repurchase of an equity interest, except to the extent that it exceeds the fair value of the equity instruments granted measured at the repurchase date.

4 Share-based payments and group entities

SECTION INTRODUCTION
Group companies may enter into share-based payment transactions which are to be settled by another company within the same group.

In some instances, one group company receives goods or services from suppliers or employees and payment is made for these by another group company granting its own equity instruments. In other words, one company receives the goods or services and another company in the same group provides payment. This is the case, for example, if a subsidiary’s employees are awarded options over the shares of the parent company.
In this case SFRS(I) 2 applies to both the entity receiving the goods or services and the entity incurring the obligation. This ensures that the entity receiving goods or services recognises an expense.
4.1 Receiving entity

In group share-based payment transactions, the entity receiving the goods or services will recognise the transaction as an equity-settled share-based payment transaction only if:

- The awards granted are its own equity instruments; or
- It has no obligation to settle the transaction.

In all other circumstances, the entity will measure the transaction as a cash-settled share-based payment.

4.2 Settling entity

The entity responsible for settling the transaction will recognise it as an equity-settled share-based payment only if the transaction is settled in its own equity instruments. In all other circumstances, the transaction will be recognised by the entity that settles the award as a cash-settled share-based payment.

4.3 Classification of group share-based payment arrangements

The table below summarises the method of accounting required for group share-based payment arrangements in the financial statements of each individual company and the group financial statements. For ease the two companies are assumed to be parent and subsidiary although this is not necessarily the case:

<table>
<thead>
<tr>
<th>Receiving entity</th>
<th>Settling entity</th>
<th>Method of settlement</th>
<th>Subsidiary accounts</th>
<th>Parent accounts</th>
<th>Group accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidiary</td>
<td>Subsidiary</td>
<td>Equity of subsidiary</td>
<td>Equity</td>
<td>N/A</td>
<td>Equity</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>Subsidiary</td>
<td>Cash</td>
<td>Cash</td>
<td>N/A</td>
<td>Cash</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>Subsidiary</td>
<td>Equity of parent</td>
<td>Cash</td>
<td>N/A</td>
<td>Equity</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>Parent</td>
<td>Equity of parent</td>
<td>Equity</td>
<td>Equity</td>
<td>Equity</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>Parent</td>
<td>Cash</td>
<td>Equity</td>
<td>Cash</td>
<td>Cash</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>Parent</td>
<td>Equity of subsidiary</td>
<td>Equity</td>
<td>Cash</td>
<td>Equity</td>
</tr>
</tbody>
</table>

4.4 Transfer of employees between group entities

When an employee of a group transfers to another group entity, any equity settled share based payments that the employee is entitled to should continue to be accounted for in accordance with SFRS(I) 2 and in particular the amount recorded should be based on the grant date fair value (ie there should be no re-measurement at the date of transfer).

Example

Ocean Wave Ltd, the parent company of the Ocean Group, awards share appreciation rights to a senior manager of its subsidiary Seabird Ltd on 1 January 20X4. At the end of a two-year vesting period, on 1 January 20X6, Ocean Wave Ltd will pay cash to the manager equivalent to the difference between Ocean Wave's share price at the grant date and the vesting date. The fair value of the award is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 January 20X4</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>31 December 20X4</td>
<td>$1,300,000</td>
</tr>
<tr>
<td>31 December 20X5</td>
<td>$1,500,000</td>
</tr>
</tbody>
</table>

Both companies have a year end of 31 December. The manager remains employed throughout
Explain how this transaction is accounted for in the individual financial statements of Ocean Wave Ltd and Seabird Ltd and the Ocean Group consolidated financial statements in the years ended 31 December 20X4 and 20X5. You should state the journal entries to be recorded in each.

**Solution**

**Seabird Ltd is the receiving company.** In Seabird Ltd's individual financial statements, SFRS(I) 2 requires the award to be treated as equity-settled, because the subsidiary does not have an obligation to settle the transaction. Therefore an expense is recognised in Seabird's statement of profit or loss over the two-year vesting period based on the grant date fair value, with a corresponding credit recognised in equity.

In the year ended 31 December 20X4 and 20X5 the transaction is recognised by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Staff costs</td>
<td>Equity 600,000</td>
</tr>
</tbody>
</table>

After the two year vesting period the equity balance is $1,200,000. This credit to equity is treated as capital contribution from Ocean Wave Ltd, as the parent company is compensating Seabird's employees at no cost to the subsidiary.

**Ocean Wave Ltd is the settling company.** In Ocean Wave's individual financial statements, there is no share-based payment expense as the employee is not providing service to the parent company. Instead the share-based payment transaction results in a debit to 'Investment in subsidiary'. As the transaction is not settled in Ocean Wave's own equity instruments, this is treated as a cash-settled share-based transaction and the corresponding entry is to a liability account. This is recorded at fair value at each reporting date. The journal entry recorded in the year ended 31 December 20X4 is therefore ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in subsidiary</td>
<td>650,000</td>
</tr>
<tr>
<td>Liability</td>
<td>650,000</td>
</tr>
</tbody>
</table>

In the year ended 31 December 20X5 the journal entry is ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in subsidiary</td>
<td>850,000</td>
</tr>
<tr>
<td>Liability</td>
<td>850,000</td>
</tr>
</tbody>
</table>

After the two year vesting period the investment in subsidiary and liability balance is $1,500,000.

In the consolidated financial statements the transaction is treated as a cash-settled share-based payment as the Ocean group has received services in consideration for cash payments based on the price of the Group's equity instruments. Therefore in the consolidated financial statements the following should be recognised:

In the year ended 31 December 20X4

1. Staff costs totalling $650,000
2. A liability of $650,000

In the year ended 31 December 20X5

1. Staff costs totalling $850,000
2. A liability of $850,000

Practically this is achieved by way of a consolidation adjustment to:

- Eliminate the equity balance in the subsidiary's financial statements against the investment in subsidiary balance in the parent's financial statements
- Transfer the difference to the staff costs account

Therefore at 31 December 20X4 the consolidation adjustment is ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>600,000</td>
</tr>
<tr>
<td>Staff costs</td>
<td>50,000</td>
</tr>
<tr>
<td>Investment in subsidiary</td>
<td>650,000</td>
</tr>
</tbody>
</table>
At 31 December 20X5 the consolidation adjustment is ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Equity</th>
<th>1,200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Staff costs</td>
<td>250,000</td>
</tr>
<tr>
<td>DEBIT</td>
<td>Retained earnings</td>
<td>50,000</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Investment in subsidiary</td>
<td>1,500,000</td>
</tr>
</tbody>
</table>

**SECTION SUMMARY**

Group settled share-based payment transactions must be recognised in accordance with SFRS(I) 2 in both the receiving and settling companies' accounts. In the receiving company's accounts the transaction is treated as equity-settled only if settlement is in its own equity instruments or it has no obligation to settle the transaction. In the settling company's accounts the transaction is treated as equity-settled only if settlement is in its own equity instruments.

**5 Disclosure**

**SECTION INTRODUCTION**

SFRS(I) 2 has extensive disclosure requirements.

SFRS(I) 2 requires disclosures in respect of:

(a) The nature and extent of share-based payment arrangements that existed during a period

(b) How the fair value of goods or services received or the fair value of equity instruments granted in a period was determined

(c) The effect of share-based payment transactions on profit or loss and financial position

**5.1 Nature and extent of share-based payment arrangements**

The following should be disclosed in respect of the nature and extent of share-based payment arrangements:

(a) A description of each type of share-based payment arrangement that existed at any time during the period

(b) The number and weighted average exercise price of share options outstanding at the start and end of the period and granted, forfeited, exercised and expired in the period

(c) The weighted average share price at the date of exercise for share options exercised in the period

(d) The range of exercise prices and remaining contractual life for share options outstanding at the end of the period
5.2 Fair values

In respect of fair values, SFRS(I) 2 requires disclosure of the following in respect of the measurement of equity instruments granted:

(a) The weighted average fair value of options granted during the period at the measurement date and information on how fair value was established

(b) The weighted average fair value of other equity instruments granted during the period at the measurement date and information on how fair value was established

(c) Details of modifications during the period

5.3 Effect on profit or loss and financial position

The following should be disclosed:

(a) The total expense recognised in the period in respect of share-based payments

(b) The carrying amount of liabilities at the end of the period and the intrinsic value of liabilities which had vested by the end of the period

An estimate of the amount that an entity expects to have to transfer to the tax authorities to settle an employee’s tax obligation where there is a net settlement feature should also be disclosed. The required disclosures can be seen in note 5 of the Singapore Airlines Annual Report 2017/18 on pages 132–136.


SECTION SUMMARY

Disclosure is required in respect of the nature and extent of share-based payment arrangements that existed during a period, how fair values were determined and the effect of share-based payments on profit or loss and financial position in a period.

6 Share-based payments and deferred tax

SECTION INTRODUCTION

An entity may receive a tax deduction in respect of share-based payments that is different in timing or amount from the related expense recognised in profit or loss.

6.1 Issue

Accounting for deferred tax arising on share-based payments is addressed in SFRS(I) 1–12 Income Taxes. Briefly, a temporary difference is likely to arise in respect of share-based payments, since the tax treatment of share-based payments differs from the accounting treatment:

6.2 Equity-settled share-based payments

- An entity recognises an accounting expense for share options granted under SFRS(I) 2 throughout the vesting period, but may not receive a tax deduction until the options are exercised; and
- The entity recognises the accounting expense based on the fair value of instruments at the grant date, but receives the tax deduction based on the share price on the exercise date.
The tax benefit is therefore received after the accounting benefit and so this is a deductible temporary difference resulting in a deferred tax asset.

### 6.2.1 Measurement

The deductible temporary difference is measured as:

- **Carrying amount of share-based payment expense**: $
- **Less tax base of share-based payment expense**: 
  
  - (estimated amount tax authorities will permit as a deduction in future periods, based on year-end information)

- **Deferred tax asset at X%**: $X$

| Carrying amount of share-based payment expense | $  |
| Less tax base of share-based payment expense |  |
| (estimated amount tax authorities will permit as a deduction in future periods, based on year-end information) | (X) |
| Deductible temporary difference | (X) |
| Deferred tax asset at X% | X |

If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates also to an equity item. The excess is therefore recognised directly in equity.

### Example

On 1 January 20X2, Geylang Foods Ltd granted 5,000 share options to an employee which vest two years later on 31 December 20X3. The fair value of each option measured at the grant date was $3.

Tax law in the jurisdiction in which the entity operates allows a tax deduction of the intrinsic value of the options on exercise. The intrinsic value of the share options was $1.20 at 31 December 20X2 and $3.40 at 31 December 20X3, on which date the options were exercised.

Assume a tax rate of 19%.

Show the deferred tax accounting treatment of the above transaction at 31 December 20X2, 31 December 20X3 (before exercise), and on exercise.

### Solution

<table>
<thead>
<tr>
<th>31.12.20X2</th>
<th>31.12.20X3 Before exercise</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount of share-based payment expense</td>
<td>$</td>
</tr>
<tr>
<td>Less: Tax base of share-based payment expense</td>
<td>$</td>
</tr>
<tr>
<td>(5,000 × $1.20 × ½)/(5,000 × $3.40)</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Temporary difference</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Deferred tax asset @ 19%</td>
<td>570</td>
</tr>
<tr>
<td>Deferred tax (CREDIT SPL) (3,230 – 570 – (Working) 380)</td>
<td>870</td>
</tr>
<tr>
<td>Deferred tax (CREDIT Equity) (Working)</td>
<td>0</td>
</tr>
</tbody>
</table>

On exercise, the deferred tax asset is replaced by a current tax asset. The double entry is ($):

- **31 December 20X2**: DEFERRED TAX ASSET 570
- **31 December 20X3**: DEFERRED TAX ASSET 2,660
- **31 December 20X3**: CURRENT TAX ASSET 3,230

<table>
<thead>
<tr>
<th>31 December 20X2</th>
<th>DEFERENCE</th>
<th>Deferred tax asset</th>
<th>570</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CREDIT</td>
<td>Income tax (profit or loss)</td>
<td>570</td>
</tr>
<tr>
<td>31 December 20X3</td>
<td>DEFERENCE</td>
<td>Deferred tax asset</td>
<td>2,660</td>
</tr>
<tr>
<td></td>
<td>CREDIT</td>
<td>Equity</td>
<td>380</td>
</tr>
<tr>
<td></td>
<td>CREDIT</td>
<td>Income tax (profit or loss)</td>
<td>2,280</td>
</tr>
<tr>
<td>31 December 20X3</td>
<td>DEFERENCE</td>
<td>Current tax asset</td>
<td>3,230</td>
</tr>
<tr>
<td></td>
<td>CREDIT</td>
<td>Deferred tax asset</td>
<td>3,230</td>
</tr>
</tbody>
</table>
Working

<table>
<thead>
<tr>
<th></th>
<th>31.12.20X2 $</th>
<th>31.12.20X3 $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting expense recognised</td>
<td>7,500</td>
<td>15,000</td>
</tr>
<tr>
<td>Tax deduction</td>
<td>(3,000)</td>
<td>(17,000)</td>
</tr>
<tr>
<td>Excess temporary difference</td>
<td>0</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Excess deferred tax asset to equity @ 19%</td>
<td>0</td>
<td>380</td>
</tr>
</tbody>
</table>

6.3 Cash-settled share-based payments

Cash-settled share-based payments, such as share appreciation rights issued to employees, are treated in exactly the same way as other expenses where there is a timing difference between the accounting recognition and any tax deduction.

Therefore if a tax deduction is available only when payment is made, a deductible taxable temporary difference arises, calculated as the difference between the liability recognised and the tax base of nil. This results in a deferred tax asset, which will increase in each year of the vesting period and then reverse when the rights are exercised.
**SFRS(I) 1-12**

**Share-based Payment**

Deferred tax implications

Recognised over vesting period or immediately if no vesting period

Equity settled transactions

Cash settled transaction

Transactions in which either party can choose

Group settled share-based payments

DEBIT Expense/asset CREDIT Equity

DEBIT Expense/asset CREDIT Liability

If fair value of goods or services cannot be reliably measured

Measuring at fair value of equity instrument granted

Who has choice of settlement?

Receiving company

Settling company

Entity

Counterparty

Does the entity have a present obligation to settle in cash?

Yes

No

Treat as cash-settled share-based payment

Treat as equity-settled share-based payment

Is the transaction with parties other than employees and FV measured directly?

Yes

No

Equity = FV of goods and services received – fair value of debt component

FV of compound instrument estimated as a whole
Vesting Conditions

- Service conditions
- Performance conditions
  - Non-market based
  - Market based

Taken into account when determining the number of equity shares that will vest

Taken into account when calculating the fair value of an equity instrument at measurement date
Quick Quiz

1. What is a cash-settled share-based payment transaction?

2. What is the grant date?

3. If an entity has entered into an equity-settled share-based payment transaction, what should it recognise in its financial statements?

4. Where an entity has granted share options to its employees in return for services, how is the transaction measured?

5. What is a modification?
Answers to Quick Quiz

1. A transaction in which the entity receives goods or services in exchange for amounts of cash that are based on the price (or value) of the entity’s shares or other equity instruments of the entity.

2. The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the other party have a shared understanding of the terms and conditions of the arrangement.

3. The goods or services received and a corresponding increase in equity.

4. By reference to the fair value of the equity instruments granted, measured at grant date.

5. A modification is an amendment to the terms and conditions on which equity instruments were granted. It may include a cancellation or settlement.

Answers to Questions

15.1 Equity-settled share-based payment 1

SFRS(I) 2 requires the entity to recognise the remuneration expense, based on the fair value of the share options granted, as the services are received during the three-year vesting period.

In 20X1 and 20X2 the entity estimates the number of options expected to vest (by estimating the number of employees likely to leave) and bases the amount that it recognises for the year on this estimate.

In 20X3 it recognises an amount based on the number of options that actually vest. A total of 55 employees left during the three-year period and therefore 34,500 options ((400 – 55) × 100) vested.

The amount recognised as an expense for each of the three years is calculated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Cumulative expense at year-end</th>
<th>Expense for year</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$213,333</td>
<td>$213,333</td>
</tr>
<tr>
<td>20X2</td>
<td>$400,000</td>
<td>$186,667</td>
</tr>
<tr>
<td>20X3</td>
<td>$690,000</td>
<td>$290,000</td>
</tr>
</tbody>
</table>

15.2 Equity-settled share-based payment 2

The remuneration expense for the year is based on the fair value of the options granted at the grant date (1 January 20X3). As five of the 200 employees left during the year, a best estimate, based on the facts, is that 20 employees will leave during the four-year vesting period and that therefore 45,000 options (250 × 180) will actually vest.

Therefore, the entity recognises a remuneration expense of $135,000 (45,000 × $12 × ¼) in profit or loss and a corresponding increase in equity of the same amount. The fair value of the options is not subsequently re-measured after grant date.
15.3 Share-based payment 3

(a) Accounting entries

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>31.12.X1</td>
<td>Employee costs</td>
<td>188,000</td>
<td>Equity reserve $((800 – 95) \times 200 \times $4 \times 1/3)</td>
</tr>
<tr>
<td>31.12.X2</td>
<td>Employee costs (W1)</td>
<td>201,333</td>
<td>Equity reserve</td>
</tr>
<tr>
<td>31.12.X3</td>
<td>Employee costs (W2)</td>
<td>202,667</td>
<td>Equity reserve</td>
</tr>
</tbody>
</table>

Issue of shares:

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cash ($740 \times 200 \times $1.50)</td>
<td>222,000</td>
<td>Share capital</td>
</tr>
<tr>
<td></td>
<td>Equity reserve</td>
<td>592,000</td>
<td></td>
</tr>
</tbody>
</table>

Workings

1. **Equity reserve at 31.12.X2**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity c/f $((800 – 70) \times 200 \times $4 \times 2/3)$</td>
<td>389,333</td>
</tr>
<tr>
<td>Less equity b/f</td>
<td>188,000</td>
</tr>
<tr>
<td>Charged to profit or loss</td>
<td>201,333</td>
</tr>
</tbody>
</table>

2. **Equity reserve at 31.12.X3**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity b/f</td>
<td>389,333</td>
</tr>
<tr>
<td>:. charge to profit or loss</td>
<td>201,333</td>
</tr>
<tr>
<td>Equity c/f $((800 – 40 – 20) \times 200 \times $4 \times 3/3)$</td>
<td>592,000</td>
</tr>
</tbody>
</table>

(b) Cash-settled share-based payment

If LCC had offered cash payments based on the value of the shares at vesting date rather than options, in each of the three years a liability would be shown in the statement of financial position representing the expected amount payable based on the following:

<table>
<thead>
<tr>
<th>Employees estimated at the year-end to be entitled to rights at the vesting date</th>
<th>Number of rights each</th>
<th>Fair value of each right at year-end</th>
<th>Cumulative proportion of vesting period elapsed</th>
</tr>
</thead>
<tbody>
<tr>
<td>No of employees</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The movement in the liability would be charged to profit or loss representing further entitlements received during the year and adjustments to expectations accrued in previous years.

The liability would continue to be adjusted (resulting in a profit or loss charge) for changes in the fair value of the right over the period between when the rights become fully vested. It would then be reduced for cash payments.
Financial instruments is a complex and controversial area. The numbers involved in financial instruments are often huge, but don't let this put you off. In this chapter we aim to simplify the topic as much as possible and to focus on the important issues.
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Principles of Financial Instruments Reporting</strong></td>
<td></td>
</tr>
<tr>
<td>Apply, discuss and explain the recognition and derecognition of financial assets and financial liabilities.</td>
<td>3</td>
</tr>
<tr>
<td>Apply, discuss and explain the classification of financial assets and financial liabilities and their measurement and disclosure.</td>
<td>3</td>
</tr>
<tr>
<td>Apply, discuss and explain the treatment of gains and losses arising from financial assets and financial liabilities.</td>
<td>3</td>
</tr>
<tr>
<td>Apply, discuss and explain the treatment of impairment of financial assets.</td>
<td>3</td>
</tr>
<tr>
<td><strong>Derivatives and Hedging</strong></td>
<td></td>
</tr>
<tr>
<td>Account for derivative financial instruments and simple embedded derivatives.</td>
<td>2</td>
</tr>
<tr>
<td>Outline the principles of hedge accounting and account for fair value hedges and cash flow hedges including hedge effectiveness.</td>
<td>2</td>
</tr>
<tr>
<td>Explain the importance of documentation of purported hedging transactions for the purposes of applying hedge accounting.</td>
<td>2</td>
</tr>
<tr>
<td><strong>Emerging Trends</strong></td>
<td></td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments.</td>
<td>1</td>
</tr>
</tbody>
</table>

**ESSENTIAL READING**


1 Financial instruments

**SECTION INTRODUCTION**

A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability of another.

1.1 Background

If you read the financial press you will probably be aware of rapid international expansion in the use of financial instruments. These vary from straightforward, traditional instruments, eg bonds, through to various forms of so-called ‘derivative instruments’.

In Singapore there are three current standards on financial instruments:

(a) SFRS(I) 1-32 Financial Instruments: Presentation, which deals with:

(i) The classification of financial instruments between liabilities and equity
(ii) Presentation of certain compound instruments
(b) SFRS(I) 9 *Financial Instruments* which deals with:
   (i) Recognition and derecognition
   (ii) The measurement of financial instruments
   (iii) Impairment
   (iv) Hedge accounting

(c) SFRS(I) 7 *Financial Instruments: Disclosures*, deals with disclosure requirements.

Note that SFRS(I) 1-39 is superseded by SFRS(I) 9 with effect from 1 January 2018.

1.2 Definitions

The most important definitions are common to all three standards.

### KEY TERMS

**FINANCIAL INSTRUMENT** Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

**FINANCIAL ASSET** Any asset that is:

(a) Cash

(b) An equity instrument of another entity

(c) A contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity; or

(d) A contract that will or may be settled in the entity's own equity instruments and is:
   (i) 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
   (ii) 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.

**FINANCIAL LIABILITY** Any liability that is:

(a) A contractual obligation:
   (i) To deliver cash or another financial asset to another entity, or
   (ii) To exchange financial instruments with another entity under conditions that are potentially unfavourable; or

(b) A contract that will or may be settled in the entity's own equity instruments and is:
   (i) 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
   (ii) 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.

**EQUITY INSTRUMENT** Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

**FAIR VALUE** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. 

(SFRS(I) 1-32)
A financial instrument or other contract with all three of the following characteristics:

(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the ‘underlying’);

(b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) It is settled at a future date. (SFRS(I) 9)

We should clarify some points arising from these definitions. Firstly, one or two terms above should be themselves defined.

(a) A ‘contract’ need not be in writing, but it must comprise an agreement that has ‘clear economic consequences’ and which the parties to it cannot avoid, usually because the agreement is enforceable in law.

(b) An ‘entity’ here could be an individual, partnership, incorporated body or government agency.

The definitions of financial assets and financial liabilities may seem rather circular, referring as they do to the terms financial asset and financial instrument. The point is that there may be a chain of contractual rights and obligations, but it will lead ultimately to the receipt or payment of cash or the acquisition or issue of an equity instrument.

Examples of financial assets include:

(a) Trade receivables
(b) Options
(c) Shares (when held as an investment)

Examples of financial liabilities include:

(a) Trade payables
(b) Debenture loans payable
(c) Redeemable preference (non-equity) shares
(d) Forward contracts standing at a loss

As we have already noted, financial instruments include both of the following:

(a) Basic instruments: eg receivables, payables and equity securities held
(b) Derivative instruments: eg financial options, futures and forwards, interest rate swaps and currency swaps, whether recognised or unrecognised

SFRS(I) 1-32 makes it clear that the following items are not financial instruments:

(a) Physical assets, eg inventories, property, plant and equipment, leased assets and intangible assets (patents, trademarks etc)
(b) Prepaid expenses, deferred revenue and most warranty obligations
(c) Liabilities or assets that are not contractual in nature eg statutory income taxes and deferred tax assets and liabilities
(d) Contractual rights/obligations that do not involve transfer of a financial asset, eg commodity futures contracts, operating leases
Question 16.1 Qualification

Can you give the reasons why the first two items listed above ie physical assets and prepaid expenses do not qualify as financial instruments?

Contingent rights and obligations meet the definition of financial assets and financial liabilities respectively, even though many do not qualify for recognition in financial statements. This is because the contractual rights or obligations exist because of a past transaction or event (eg assumption of a guarantee).

1.3 Derivatives

A derivative is a financial instrument that derives its value from the price or rate of an underlying item. Common examples of derivatives include:

(a) **Forward contracts**: private agreements to buy or sell an asset at a fixed price at a fixed future date eg a contract to buy US dollars at a fixed exchange rate in the future.

(b) **Futures contracts**: similar to forward contracts except that contracts are for a standardised amount and quality and are traded on an exchange rather than being a private contract, eg a contract to sell a standardised amount (1,000 barrels) of brent crude oil in the future. Futures contracts can be closed out prior to maturity.

(c) **Options**: rights (but not obligations) for the option holder to exercise at a pre-determined price; the option writer loses out if the option is exercised. Eg an option to sell gold at a fixed price per ounce.

(d) **Swaps**: agreements to swap one set of cash flows for another (normally interest rate or currency swaps eg an agreement to swap fixed loan interest for variable loan interest).

The nature of derivatives often gives rise to particular problems. The value of a derivative (and the amount at which it is eventually settled) depends on movements in an underlying item (such as an exchange rate). This means that settlement of a derivative can lead to a very different result from the one originally envisaged. A company which has derivatives is exposed to uncertainty and risk (potential for gain or loss) and this can have a very material effect on its financial performance, financial position and cash flows.

Yet because a derivative contract normally has little or no initial cost, under traditional accounting it may not be recognised in the financial statements at all. Alternatively it may be recognised only upon maturity of the financial instruments. This is clearly misleading and leaves users of the financial statements unaware of the level of risk that the company faces. Accounting standards dealing with financial instruments were developed in order to correct this situation. The accounting treatment of derivatives is considered later.

SECTION SUMMARY

SFRS(I) 1-32, SFRS(I) 7 and SFRS(I) 9 are relevant to accounting for financial instruments. A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Financial instruments may be basic instruments or derivative instruments.
2 Presentation of financial instruments

SECTION INTRODUCTION
SFRS(I) 1-32 deals with the classification of financial instruments, including splitting compound instruments between liabilities and equity.

2.1 Objective
The objective of SFRS(I) 1-32 is to:

- Classify financial instruments, from the perspective of the user, into financial assets, financial liabilities and equity instruments
- Classify related interest, dividends, losses and gains
- Clarify the circumstances in which financial assets and financial liabilities should be offset

2.2 Scope
SFRS(I) 1-32 should be applied in the presentation of all types of financial instruments, whether recognised or unrecognised.

Certain items are excluded:

- Interests in subsidiaries, unless accounted for using SFRS(I) 9 (SFRS(I) 10)
- Interests in associates and joint ventures unless accounted for using SFRS(I) 9 (SFRS(I) 1-28)
- Pensions and other post-retirement benefits (SFRS(I) 1-19)
- Insurance contracts (SFRS(I) 4 or SFRS(I) 17)
- Financial instruments, contracts and obligations under share-based payment transactions (SFRS(I) 2)

2.3 Liabilities and equity
The main thrust of SFRS(I) 1-32 here is that financial instruments should be presented according to their substance, not merely their legal form. In particular, entities which issue financial instruments should classify them (or their component parts) as either financial liabilities, or equity.

The classification of a financial instrument as a liability or as equity depends on the following:

- The substance of the contractual arrangement on initial recognition
- The definitions of a financial liability and an equity instrument

The classification of the financial instrument is made when it is first recognised and this classification will continue until the financial instrument is derecognised from the entity's statement of financial position.

How should a financial liability be distinguished from an equity instrument? The critical feature of a liability is an obligation to transfer economic benefit. Therefore a financial instrument is a financial liability if there is a contractual obligation on the issuer either to deliver cash or another financial asset to the holder or to exchange another financial instrument with the holder under potentially unfavourable conditions to the issuer.

The financial liability exists regardless of the way in which the contractual obligation will be settled. The issuer's ability to satisfy an obligation may be restricted, eg by lack of access to foreign currency, but this is irrelevant as it does not remove the issuer's obligation or the holder's right under the instrument.
Where the above critical feature is not met, then the financial instrument is an equity instrument. SFRS(I) 1-32 explains that although the holder of an equity instrument may be entitled to a pro rata share of any distributions out of equity, the issuer does not have a contractual obligation to make such a distribution.

Example

(a) Entity A has issued $10 million 6% loan stock. The loan stock is redeemable in ten years' time. The loan stock is classified as a liability because there is an obligation to transfer economic benefit, being ten years' interest of $600,000 and the principal of $10 million.

(b) Entity B has issued $20 million 9% loan stock. The loan stock is a 'perpetual debt' instrument as loan stock-holders have no right to receive a return of principal. The loan stock is classified as a liability in its entirety, because there is an obligation to transfer economic benefit, being an annual amount of interest of $1.8 million.

(c) Entity C issues preference shares amounting to $800,000. Dividends are paid at the entity's discretion and the entity has the option to redeem the shares for cash at any time in the future. The preference shares are classified as equity as there is no obligation to transfer economic benefit. Discretionary dividends do not create an obligation to transfer economic benefit even if there is a history of making distributions. Equally, the option of the issuer to redeem the shares is not a present obligation.

Although substance and legal form are often consistent with each other, this is not always the case. In particular, a financial instrument may have the legal form of equity, but in substance it is in fact a liability. Other instruments may combine features of both equity instruments and financial liabilities. For example, many entities issue preferred shares which must be redeemed by the issuer for a fixed (or determinable) amount at a fixed (or determinable) future date. Alternatively, the holder may have the right to require the issuer to redeem the shares at or after a certain date for a fixed amount. In such cases, the issuer has an obligation. Therefore the instrument is a financial liability and should be classified as such.

Question 16.2 Classification

During the financial year ended 28 February 20X5, MN Ltd issued the two financial instruments described below. For each of the instruments, identify whether it should be classified as a liability or equity, explaining in not more than 40 words each the reason for your choice. In each case you should refer to the relevant SFRS(I).

(a) Redeemable preference shares with a coupon rate 8%. The shares are redeemable on 28 February 20X9 at premium of 10%.

(b) A grant of share options to senior executives. The options may be exercised from 28 February 20X8.

2.4 Specific classification rules

In addition to providing the general guidance on the classification of financial instruments discussed above, SFRS(I) 1-32 considers certain specific instruments:

- Puttable financial instruments
- Obligations arising on liquidation
- Financial instruments with contingent settlement provisions
- Financial instruments with settlement options
- Compound instruments
- Rights issues

We shall consider each of these in turn.
2.4.1 Puttable instruments

**KEY TERM**

A **PUTTABLE INSTRUMENT** is defined as an instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

Under the basic definition of a liability, such instruments would usually be classified as liabilities because there is an unavoidable obligation to transfer cash. SFRS(I) 1-32, however, applies special rules to puttable instruments, listing a set of criteria which, if met, require these instruments to be classified as equity.

Puttable instruments that meet the definition of a financial liability are classified as equity if they have all of the following features:

(a) The holder is entitled to a pro rata share of the entity's net assets on liquidation,
(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments,
(c) All instruments in that class have identical features,
(d) Apart from the put feature, the instrument has no other characteristics that would meet the definition of a financial liability, and
(e) The total expected cash flows attributable to the instrument over its life are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of the instrument itself). Profit or loss or change in recognised net assets for this purpose is as measured in accordance with the relevant SFRS(I).

In addition to the criteria set out above, the entity must have no other instrument that has terms equivalent to (e) above and that has the effect of substantially restricting or fixing the residual return to the holders of the puttable financial instruments.

**Example**

An entity has issued puttable shares that investors may put back to the entity. These shares entitle investors to a pro rata share of net assets on liquidation and are subordinate to all other classes of instruments. When an investor puts the shares back to the entity, it charges an administration fee. The fee is 1% for shares issued to wholesale investors and 5% for shares issued to retail investors.

(a) Are the shares classified as liabilities or equity?
(b) How would classification differ if a 1% fee were charged to all investors when the shares are put back to the entity?

**Solution**

(a) The shares are classified as liabilities rather than equity. This is because different holders are charged different fees, so resulting in differing distributions. Therefore the identical features condition (condition (c) above) is failed.

(b) If the fee were the same for all investors, then the identical features condition would be met and the shares would be classified as equity (assuming that other than the put option, the shares have no further characteristics of a liability).
2.4.2 Obligations arising on liquidation

Certain financial instruments include a contractual obligation for the entity that issues them to pay the holder of the instrument a pro rata share of its net assets on liquidation.

The obligation arises because either:

- Liquidation is certain to occur and cannot be controlled by the entity; or
- Liquidation is uncertain but is at the option of the instrument holder.

As with puttable instruments, such obligations appear to meet the basic definition of a financial liability, however SFRS(I) 1-32 requires that they are classified as equity if they meet certain conditions. The conditions are similar to some of those related to puttable instruments:

(a) The holder is entitled to a pro rata share of the entity's net assets on liquidation
(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments
(c) All instruments in that class have identical features
(d) The issuer has no other financial instrument or contract that has:
   (i) Total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity; and
   (ii) The effect of substantially restricting or fixing the residual return to the puttable instrument holders.

Example

An investment fund comprises two sub-funds, a South East Asian fund and a South African fund. These funds are not considered to be entities in their own right. The investment fund has two classes of puttable share – A shares and B shares. On liquidation the A shares are entitled to a pro rata share of the residual assets in the South East Asian fund and the B shares are entitled to a pro rata share of the residual assets in the South African fund. How should the investment fund classify the shares?

Solution

Both the A shares and the B shares are classified as liabilities. This is because the holders of the shares are entitled to a pro rata share in the residual assets of different sub funds rather than the entity as a whole. Therefore condition (a) listed above is not met.

2.4.3 Contingent settlement provisions

An entity may issue a financial instrument where the way in which it is settled depends on:

(a) The occurrence or non-occurrence of uncertain future events; or
(b) The outcome of uncertain circumstances.

that are beyond the control of both the holder and the issuer of the instrument. An event that is within the control of either the issuer or the holder does not meet the definition of a contingent settlement event. For example, an entity might have to deliver cash instead of issuing equity shares depending on any of:

- Changes in a stock market index, consumer price index, interest rate or taxation requirements; or
- The issuer's future revenues, net income or debt to equity ratio.

In this situation it is not immediately clear whether the entity has an equity instrument or a financial liability. Such financial instruments should be classified as financial liabilities unless:

(a) The part of the contingent settlement provision that could require settlement in cash or another asset is not genuine (for example a provision which requires cash settlement is extremely unlikely commercially or impossible such that the term has no economic substance);
(b) The issuer can be required to settle the obligation in cash or another financial asset only in the event of liquidation of the issuer; or
(c) The instrument is a puttable instrument which has the features to be classified as equity.

Unless any of the conditions above are met, an instrument with a contingent settlement provision is classified as a liability because the issuer does not have the unconditional right to avoid delivering cash or another financial asset.

**Example**

An entity has issued a financial instrument which must be repaid in the event of a five-fold increase in the stock market index in a six month period.

Such an increase is historically unprecedented and is therefore sufficiently unlikely to be considered 'genuine'. Therefore the instrument is classified as equity.

Had the uncertain future event been a two-fold increase, this would probably be 'genuine' (ie realistically achievable) and so the instrument would have been classed as a liability.

### 2.4.4 Settlement options

The definition of a financial liability, as seen above, includes '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'.

In other words, in a derivative financial instrument:

(a) Where an entity can exchange a fixed number of shares for a fixed amount of cash (or financial asset), an instrument is not a financial liability but is instead equity or a compound instrument;
(b) Where an entity cannot exchange a fixed number of shares for a fixed amount of cash (or financial asset), an instrument is a financial liability.

As a result of this definition, it was thought that entities may attempt to avoid recognising and accounting for a financial liability simply by including in contracts an option to settle through the exchange of a fixed number of shares for a fixed amount.

SFRS(I) 1-32 therefore contains special rules in respect of settlement options in order to ensure that entities cannot avoid recognising a financial liability (or asset) in this way.

The rules state that when a derivative financial instrument gives one party a choice over how it is settled (eg, the issuer or the holder can choose whether to settle in cash or through the issue of shares), the instrument is a financial asset or a financial liability unless all the alternative settlement choices would result in it being an equity instrument.

Examples of such instruments include:

(a) A share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash is classified as a financial liability.
(b) A contract to buy or sell a non-financial item in exchange for an entity's own equity instruments where settlement can be made net in cash or another financial instrument or by exchanging financial instruments.

### 2.4.5 Compound financial instruments

Some financial instruments contain both a liability and an equity element. In such cases, SFRS(I) 1-32 requires the component parts of the instrument to be classified separately, according to the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.
One of the most common types of compound instrument is convertible debt. This creates a primary financial liability of the issuer and grants an option to the holder of the instrument to convert it into an equity instrument (usually ordinary shares) of the issuer. This is the economic equivalent of the issue of conventional debt plus a warrant to acquire shares in the future.

The split of a compound instrument is determined as follows:

(a) Calculate the value for the liability component based on similar instruments with no conversion rights.

(b) Deduct this from the instrument as a whole to leave a residual value for the equity component.

The reasoning behind this approach is that an entity's equity is its residual interest in its assets amount after deducting all its liabilities.

The sum of the carrying amounts assigned to liability and equity will always be equal to the carrying amount that would be ascribed to the instrument as a whole (ie the transaction amount).

**Example**

Fragrant Flowers Ltd issues 2,000 convertible bonds at the start of 20X2. The bonds have a three year term, and are issued at par with a face value of $1,000 per bond, giving total proceeds of $2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 ordinary shares of the company.

When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9%. At the issue date, the market price of one common share is $3. The dividends expected over the three year term of the bonds amount to 14c per share at the end of each year. The risk-free annual interest rate for a three year term is 5%.

What is the value of the equity component in the bond?

**Solution**

The liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar bonds having no conversion rights, as shown.

\[
\begin{align*}
\text{Present value of the principal: } & \ 1,544,000 \\
& (\ 2,000,000 \times 0.772) \\
\text{Present value of the interest: } & \ 303,720 \\
& (\ 120,000 \times 2.531) \\
\text{Total liability component} & \ 1,847,720 \\
\text{Equity component (balancing figure)} & \ 152,280 \\
\text{Proceeds of the bond issue} & \ 2,000,000
\end{align*}
\]

*These figures can be obtained from discount and annuity tables.

Note that although information is provided that could be used to measure the equity element (market value of shares), SFRS(I) 1-32 is clear that equity is measured as a residual interest ie the remainder of proceeds after the measurement of the liability component.

The classification of the instrument into liability and equity components is not reassessed after initial recognition, even if there are changes in the likelihood of the option being exercised. This is because it is not always possible to predict how a holder will behave. The issuer continues to have an obligation to make future payments until conversion, maturity of the instrument or some other relevant transaction takes place.
Question 16.3
Hybrid financial instrument

On 1 January 20X1, Balestier Bio Ltd issued 10,000 5% convertible bonds at their par value of $50 each. The bonds will be redeemed on 1 January 20X6. Each bond is convertible at the option of the holder at any time during the five year period. Interest on the bond will be paid annually in arrears.

The prevailing market interest rate for similar debt without conversion options at the date of issue was 6%.

Required
At what value should the equity element of the hybrid financial instrument be recognised in the financial statements of Balestier Bio at the date of issue?

2.4.6 Rights issues
Rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.

2.5 Treasury shares
Treasury shares are shares that have been bought back by the issuing company. They may be held by the company or may be sold, transferred or cancelled. Treasury shares were introduced in Singapore in 2006; previously shares which were bought back were cancelled immediately, however the law now allows them to be held in treasury up to a specified limit.

Treasury shares may be used by an entity as a form of capital restructuring, to pay stock dividends or within employee remuneration packages.

If an entity **reacquires its own equity instruments**, those instruments ('treasury shares') are **deducted from equity**. No gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Consideration paid or received is recognised directly in equity.

2.6 Interest, dividends, losses and gains
As well as looking at statement of financial position presentation, SFRS(I) 1-32 considers how financial instruments affect profit or loss (and movements in equity). The treatment varies according to whether interest, dividends, losses or gains relate to a financial liability or an equity instrument.

(a) Interest, dividends, losses and gains relating to a financial instrument (or component part) classified as a **financial liability** should be recognised as **income or expense** in profit or loss.

(b) Distributions to holders of a financial instrument classified as an **equity instrument** should be **debited directly to equity** by the issuer.

(c) **Transaction costs** of an equity transaction shall be accounted for as a **deduction from equity**; transaction costs that relate to the issue of a compound instrument are allocated to the liability and equity components in proportion to the proceeds.

2.7 Offsetting a financial asset and a financial liability
A financial asset and financial liability should **only be offset**, with the net amount reported in the statement of financial position, when an entity:

(a) Has a legally enforceable right of set off, **and**

(b) Intends to settle on a net basis, or to realise the asset and settle the liability simultaneously, ie at the same moment.
This will reflect the expected future cash flows of the entity in these specific circumstances. In all other cases, financial assets and financial liabilities are presented separately.

For example, Entity A owes a supplier $250,000, but is also owed $100,000 for services provided to that supplier. If Entity A has a legal right of set off (which may be contractual) and intends to settle a net $150,000, it may present a single balance being a payable of $150,000.

SECTION SUMMARY

- Financial instruments issued to raise capital must be classified as liabilities or equity.
- The substance of the financial instrument is more important than its legal form.
- The critical feature of a financial liability is the contractual obligation to deliver cash or another financial instrument.
- Compound instruments are split into equity and liability parts and presented accordingly.
- Interest, dividends, losses and gains are treated according to whether they relate to an equity instrument or a financial liability.

3 Recognition of financial instruments

SECTION INTRODUCTION

SFRS(I) 9 Financial Instruments states that all financial assets and liabilities should be recognised in the statement of financial position, including derivatives.

SFRS(I) 9 Financial Instruments establishes principles for recognising and measuring financial assets and financial liabilities. This standard is effective for periods beginning on or after 1 Jan 2018.

3.1 Scope

SFRS(I) 9 applies to all entities and to all types of financial instruments except those specifically excluded, as listed below.

(a) Investments in subsidiaries, associates, and joint ventures that are accounted for under SFRS(I)s 1-27, 1-28 and 10.
(b) Leases covered in SFRS(I) 16 with the following exceptions:
   (i) Finance lease receivables are subject to SFRS(I) 9 derecognition and impairment requirements
   (ii) Lease liabilities are subject to SFRS(I) 9 derecognition requirements
   (iii) Derivatives that are embedded in leases are subject to SFRS(I) 9 embedded derivatives requirements.
(c) Employee benefit plans covered in SFRS(I) 1-19
(d) Insurance contracts covered in SFRS(I) 4
16: Financial instruments  |  PART D ACCOUNTING FOR ASSETS AND LIABILITIES

(e) Equity instruments issued by the entity eg ordinary shares issued, or options and warrants covered in SFRS(I) 1-32

(f) Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date (SFRS(I) 3)

(g) Loan commitments other than those designated as financial liabilities at fair value through profit or loss, those that can be settled net in cash or another financial instrument and those to provide a loan at a below-market interest rate. All loan commitments are subject to SFRS(I) 9 derecognition requirements.

(h) Financial instruments, contracts and obligations under share-based payment transactions, covered in SFRS(I) 2:
   (i) Rights to payments to reimburse an entity for expenditure that it is required to make to settle a provision (SFRS(I) 1-37)
   (ii) Rights and obligations with are within the scope of SFRS(I) 15 unless that standard specified that SFRS(I) 9 applies

3.2 Initial recognition

Financial instruments should be recognised in the statement of financial position when the entity becomes a party to the contractual provisions of the instrument.

An important consequence of this is that all derivatives should be recognised in the statement of financial position.

Notice that this is different from the recognition criteria in the Conceptual Framework and in most other standards. Items are normally recognised when there is a probable inflow or outflow of resources and the item has a cost or value that can be measured reliably.

For example, suppose that an entity has entered into two separate contracts:
   (a) A firm commitment (an order) to buy a specific quantity of iron
   (b) A forward contract to buy a specific quantity of iron at a specified price on a specified date, provided delivery of the iron is not taken

Contract (a) is a normal trading contract. The entity does not recognise a liability for the iron until the goods have actually been delivered. (Note that this contract is not a financial instrument because it involves a physical asset, rather than a financial asset.)

Contract (b) is a financial instrument. Under SFRS(I) 1-39, the entity recognises a financial liability (an obligation to deliver cash) on the commitment date, rather than waiting for the closing date on which the exchange takes place.

Note that planned future transactions, no matter how likely, are not assets and liabilities of an entity – the entity has not yet become a party to the contract.

3.3 Derecognition

3.3.1 Financial assets

Derecognition is the removal of a previously recognised financial instrument from an entity's statement of financial position.

An entity should derecognise a financial asset when:
   (a) The contractual rights to the cash flows from the financial asset expire, or
   (b) The entity transfers substantially all the risks and rewards of ownership of the financial asset to another party
Question 16.4

Can you think of an example of a sale of a financial asset in which:

(a) An entity has transferred substantially all the risks and rewards of ownership?
(b) An entity has retained substantially all the risks and rewards of ownership?

3.3.2 Financial liabilities

An entity should derecognise a financial liability when it is extinguished – ie, when the obligation specified in the contract is discharged or cancelled or has expired. A financial liability is also derecognised where:

- The borrower and lender exchange debt instruments with substantially different terms; or
- The terms of the existing financial liability are substantially modified.

Terms are substantially different where the discounted present value of cash flows under the new terms, discounted using the original effective interest rate, is at least 10% different from the discounted present value of the cash flows of the original liability.

In both of these cases, a new financial liability is recognised in the place of the derecognised financial liability.

Where an exchange of financial liabilities or the substantial modification of terms of a financial liability results in derecognition, the costs or fees related to the exchange or modification form part of the gain or loss on disposal (see section 3.3.4).

Example

On 1 May 20X4 Cloudburst Co issues $10 million 10% loan stock redeemable at par after ten years. Interest is paid annually in arrears. On 1 May 20X9, Cloudburst Co and the loan stock-holders agree to a modification with the following terms:

- No further interest payments are made
- The loan stock is redeemed on the original date for $17 million

Legal and other fees relating to the modification amount to $500,000. Assume the borrowing cost of Cloudburst has not changed over the years.

How is this modification accounted for by Cloudburst Co?

Solution

The present value of remaining cash flows is compared with the present value of cash flows under the new terms. The present value of the cash flows arising on the old terms is $10 million:

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0</td>
<td>$1m/1.1</td>
<td>$909,091</td>
</tr>
<tr>
<td>20X1</td>
<td>$1m/1.1²</td>
<td>$826,446</td>
</tr>
<tr>
<td>20X2</td>
<td>$1m/1.1³</td>
<td>$751,315</td>
</tr>
<tr>
<td>20X3</td>
<td>$1m/1.1⁴</td>
<td>$683,013</td>
</tr>
<tr>
<td>20X4</td>
<td>$1m/1.1⁵</td>
<td>$6,830,135</td>
</tr>
<tr>
<td>Total</td>
<td>$10m</td>
<td>$10,000,000</td>
</tr>
</tbody>
</table>
The present value of cash flows arising after the modification is $11,055,662:

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal ($17m/1.15)</td>
<td>10,555,662</td>
</tr>
<tr>
<td>Fees incurred</td>
<td>500,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>11,055,662</strong></td>
</tr>
</tbody>
</table>

The increase in cash flows represents more than a 10% change from $10 million. Therefore the original financial liability is derecognised and a new financial liability on the new terms is recognised. The new financial liability is initially measured at fair value in accordance with SFRS(I) 9 and any difference between this amount and the derecognised financial liability is recognised in profit or loss.

### 3.3.3 Partial derecognition

It is possible for only part of a financial asset or liability to be derecognised. This is allowed if the part comprises:

- Only specifically identified cash flows; or
- Only a fully proportionate (pro rata) share of the total cash flows.

For example, if an entity holds a bond it has the right to two separate sets of cash inflows: those relating to the principal and those relating to the interest. It could sell the right to receive the interest to another party while retaining the right to receive the principal.

### 3.3.4 Gain or loss on derecognition

On derecognition, the amount to be included in net profit or loss for the period is calculated as follows.

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount of asset/liability (or the portion of asset/liability) transferred</td>
<td>X</td>
</tr>
<tr>
<td>Less: Proceeds received/paid</td>
<td>(X)</td>
</tr>
<tr>
<td>Difference to net profit/loss</td>
<td>X</td>
</tr>
</tbody>
</table>

Where only part of a financial asset is derecognised, the carrying amount of the asset should be allocated between the part retained and the part transferred based on their relative fair values on the date of transfer. A gain or loss should be recognised based on the proceeds for the portion transferred.

### 3.3.5 More detail on transfers

The complexity of financial transactions and the difficulty of establishing whether the transfer of legal title leaves residual risk and reward exposure as well as control and involvement, has prompted the IASB to produce a fairly prescriptive set of principles to aid companies in the derecognition of financial assets.
The following points relate to this flowchart.

(a) If the contractual rights to receive the cash flows from the asset have expired or have been wholly transferred, the whole of the asset should be derecognised.

(b) If an entity has sold just a portion of the cash flows arising from an asset, only part of the asset should be derecognised.

(c) If substantially all the risks and rewards of ownership have been transferred, the financial asset should be derecognised; if they have not, it should not.

(d) If the entity has neither retained nor transferred all the risks and rewards of ownership, it should determine whether it has retained control of the financial asset. If it has, it continues to recognise the asset to the extent of its continuing involvement.
Some common transactions, such as repurchase agreements and debt factoring are employed in order to try to remove assets from the statement of financial position.

Remember always to apply the principle of substance over form.

**Question 16.5**

<table>
<thead>
<tr>
<th>Derecognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Roldan Co has receivables with a carrying amount of $26 million. It sells the full receivables balance to a financing company for $23 million in a factoring transaction with full recourse. Roldan will reimburse the financing company in cash if it recovered less than $23 million from Roldan's customers.</td>
</tr>
<tr>
<td>(b) Sagres Co sells an investment to another entity for $450,000. On the sale date Sagres entered into a contract with the other entity to repurchase the investment two months later for $480,000.</td>
</tr>
</tbody>
</table>

**Required**

Advise whether the financial asset should be derecognised in each scenario.

**SECTION SUMMARY**

- All financial assets and liabilities should be recognised in the statement of financial position when the entity becomes a party to the contractual provisions of the instrument.
- Financial assets should be derecognised when the rights to the cash flows from the asset expire or where substantially all the risks and rewards of ownership are transferred to another party.
- Financial liabilities should be derecognised when they are extinguished.

**4 Classification of financial instruments**

**SECTION INTRODUCTION**

SFRS(I) 9 requires that financial assets are classified as one of three types depending on the business model within which they are held and associated contractual cash flows; financial liabilities are classified as one of two types.

**4.1 Financial assets**

SFRS(I) 9 Financial Instruments requires that financial assets are classified as measured at either:

- Amortised cost, or
- Fair value through other comprehensive income, or
- Fair value through profit or loss.

This classification is made on the basis of both:

(a) The entity's business model for managing the financial asset, and
(b) The contractual cash flow characteristics of the financial asset.
The following flow diagram illustrates what criteria must be met to classify a financial asset as measured at amortised cost and fair value through other comprehensive income:

Is the objective of the business model within which the asset is held only to collect contractual cash flows?

Yes → Do the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding?

Yes → Amortised cost

No → Fair value through profit or loss (FVTPL)

Is the objective of the business model within which the asset is held to:

(a) collect contractual cash flows and
(b) sell financial assets?

Yes → Do the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding?

Yes → Fair value through other comprehensive income (FVTOCI)

No → No

Therefore in order to be classified as measured at amortised cost, a financial asset:

1. Must be held within a business model whose objective is to hold assets to collect contractual cash flows; and
2. Must give rise to contractual cash flows on specified dates that are solely payments of principal and interest on the principal outstanding.

In order to be classified as measured at fair value through other comprehensive income, a financial asset:

1. Must be held within a business model whose objective is to hold assets to collect contractual cash flows and sell financial assets; and
2. Must give rise to contractual cash flows on specified dates that are solely payments of principal and interest on the principal outstanding.

The rationale behind the classification criteria is to provide useful information to users of the financial statements. Where a debt instrument is held in the long term to collect contractual cash flows, the fair value of that instrument is of limited relevance to users. Conversely, where this is not the case, or where the purpose of holding an instrument is to collect income but also to sell the asset, the fair value gives an indication of selling price and so becomes more relevant.

A list of examples to illustrate contractual cash flows that are solely payments of principal and interest on the principal outstanding are provided in Paragraph B4.1.13 of SFRS(I) 9 Appendix B Application Guidance.

You should also read Paragraph B4.1.4 of SFRS(I) 9 Appendix B Application Guidance for examples of when the objective of an entity's business model may be to hold financial assets to collect contractual cash flows.

Examples of when the objective of an entity's business model may be achieved by collecting contractual cash flows and selling financial assets are provided in Paragraph B4.1.4C of Appendix B Application Guidance.
4.1.1 Application of classification criteria

An application of these rules means that:

(a) **Equity investments** must be measured at fair value through profit or loss. This is because contractual cash flows on specified dates are not a characteristic of equity instruments.

An entity may make an irrevocable election at initial recognition to measure an equity instrument at fair value through other comprehensive income where the instrument is not held for trading.

(b) **Debt instruments** may be measured at amortised cost or fair value depending on whether the criteria given above are met.

Even where the criteria are met at initial recognition, a debt instrument may be designated as measured as fair value through profit or loss if doing so eliminates inconsistency (sometimes referred to as an ‘accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

(c) An investment in a hybrid instrument (such as convertible debt) must be measured at fair value through profit or loss since the inclusion of a conversion option does not represent payments of principal and interest.

(d) **All derivatives** are measured at fair value through profit or loss.

Note that trade receivables are initially measured in accordance with SFRS(I) 15.

4.2 Financial liabilities

On recognition, SFRS(I) 9 requires that financial liabilities are classified as measured at either:

(a) At fair value through profit or loss, or

(b) Financial liabilities at amortised cost.

A financial liability is classified at fair value through profit or loss if:

(a) It is held for trading, or

(b) Upon initial recognition it is designated at fair value through profit or loss.

Derivatives are always measured at fair value through profit or loss.

4.3 Reclassification

Although on initial recognition financial instruments must be classified in accordance with the requirements of SFRS(I) 9, in some cases they may be subsequently reclassified. SFRS(I) 9 requires that when an entity changes its business model for managing financial assets, it should reclassify all affected financial assets. This reclassification applies only to debt instruments, as equity instruments must be classified as measured at fair value.

Financial liabilities may not be reclassified.
5 Measurement of financial instruments

SECTION INTRODUCTION
The measurement of financial assets and liabilities subsequent to initial recognition depends on their SFRS(I) 9 classification.

5.1 Initial measurement of financial instruments
Financial instruments (other than trade receivables) are initially measured at fair value. Unless a financial instrument is classified as fair value through profit or loss (see below), this amount is adjusted for directly attributable transaction costs:

<table>
<thead>
<tr>
<th>Type of Financial Instrument</th>
<th>Fair Value Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset (not at fair value through profit or loss)</td>
<td>Fair value + transaction costs</td>
</tr>
<tr>
<td>Financial liability (not at fair value through profit or loss)</td>
<td>Fair value - transaction costs</td>
</tr>
</tbody>
</table>

Where a financial asset or liability is measured at fair value through profit or loss, transaction costs are recognised in profit or loss immediately.

Trade receivables are recognised at their transaction price unless they contain a significant financing component in line with SFRS(I) 15 (Chapter 17).

5.1.1 Determination of fair value
In most cases fair value is the transaction price and therefore a financial instrument is recognised at an amount equal to consideration paid/payable or received/receivable.

If fair value is determined to differ from transaction price, the following approach is taken:

(a) If fair value is determined based on an SFRS(I) 13 Level 1 input, the difference between fair value and transaction price is recognised as a gain or loss immediately;

(b) If fair value is not determined based on an SFRS(I) 13 Level 1 input, the difference is deferred and recognised as a gain or loss only to the extent that it arises from a change in a factor that market participants would take into account when pricing the asset or liability.
5.2 Subsequent measurement of financial assets

The subsequent measurement of financial assets depends on their SFRS(I) 9 classification as amortised cost, fair value through other comprehensive income or fair value through profit or loss.

5.2.1 Amortised cost

A term that is relevant to both financial assets and liabilities is amortised cost.

**KEY TERMS**

The **amortised cost of a financial asset or financial liability** is the amount at which the financial asset or liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and for financial assets, adjusted for any loss allowance.

The **effective interest method** is the method that is used in the calculation of the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.

(SFRS(I) 9)

Interest revenue is calculated by applying the effective interest rate to the carrying amount of a financial asset. This amount is recognised in profit or loss; interest equal to the coupon rate is received from the counterparty and the balance of interest income in a period accrues to the outstanding financial asset balance, as the following example illustrates.

**Example**

On 1 January 20X1 Abacus Ltd purchases a quoted debt instrument for its fair value of $1,000. The debt instrument is due to mature on 31 December 20X5 and the entity has the intention to hold the debt instrument until that date in order to collect contractual cash flows. The instrument has a principal amount of $1,250 and the instrument carries fixed interest at 4.72% that is paid annually. (The effective interest rate is 10%.)

How should Abacus Ltd account for the debt instrument over its five year term?

**Solution**

The financial asset is classified as measured at amortised cost since it is held within a business model to collect contractual cash flows and gives rise to contractual cash flows on specified dates that are solely payments of principal and interest on the principal outstanding.

Abacus Ltd will receive interest of $59 (1,250 \times 4.72\%) each year and $1,250 when the instrument matures.

Abacus must allocate the discount of $250 and the interest receivable over the five year term at a constant rate on the carrying amount of the debt. To do this, it must apply the effective interest rate of 10%.
The following table shows the allocation over the years.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amortised cost at beginning of year $</th>
<th>Profit or loss: Interest income for year (@ 10%) $</th>
<th>Interest received during year (cash inflow) ($)</th>
<th>Amortised cost at end of year $</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>1,000</td>
<td>100</td>
<td>(59)</td>
<td>1,041</td>
</tr>
<tr>
<td>20X2</td>
<td>1,041</td>
<td>104</td>
<td>(59)</td>
<td>1,086</td>
</tr>
<tr>
<td>20X3</td>
<td>1,086</td>
<td>109</td>
<td>(59)</td>
<td>1,136</td>
</tr>
<tr>
<td>20X4</td>
<td>1,136</td>
<td>113</td>
<td>(59)</td>
<td>1,190</td>
</tr>
<tr>
<td>20X5</td>
<td>1,190</td>
<td>119</td>
<td>(1,250 + 59)</td>
<td>–</td>
</tr>
</tbody>
</table>

Each year the carrying amount of the financial asset is increased by the interest income for the year and reduced by the interest actually received during the year. The required journal entries in 20X1 are (in $):

DEBIT   Financial asset at amortised cost 1,000
CREDIT  Cash/bank 1,000
to recognise the financial asset on 1 January 20X1

DEBIT   Financial asset at amortised cost (100 – 59) 41
DEBIT   Cash/bank 59
CREDIT  Profit or loss 100
to recognise interest income at the effective rate

Other amounts recognised in profit or loss in respect of financial assets at amortised cost are:

- Impairment losses (section 6)
- Foreign exchange differences
- Gains or losses on derecognition.

5.2.2 Fair value through other comprehensive income (debt instruments)

Despite the classification name, where a debt instrument is measured at fair value through other comprehensive income, certain amounts are recognised in profit or loss. These include:

- Interest calculated using the effective interest method
- Impairment losses (see section 6)
- Foreign exchange gains and losses

Any remaining change in fair value is recognised in other comprehensive income. Therefore any amounts that would be recognised in profit or loss if the asset were classified as measured at amortised cost are still recognised in profit or loss.

Example

The facts are as in the example above, however Abacus Ltd holds the debt instrument within a business model with the intention of collecting contractual cash flows and selling assets. The fair value of the debt instrument is $1,210 at 31 December 20X1, $1,340 at 31 December 20X2, $1,400 at 31 December 20X3 and $1,445 at 31 December 20X4.

How should Abacus Ltd account for the debt instrument over its five year term?
Solution

The financial asset is classified as measured at fair value through other comprehensive income since it is held within a business model to collect contractual cash flows and sell assets and gives rise to contractual cash flows on specified dates that are solely payments of principal and interest on the principal outstanding.

The following table shows the measurement over the term:

<table>
<thead>
<tr>
<th>Year</th>
<th>Carrying amount b/f</th>
<th>Profit or loss: Interest income for year (@ 10%)</th>
<th>Interest and/or principal received during year (cash inflow)</th>
<th>Gain or loss on remeasurement to fair value/derecognition</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>1,000</td>
<td>100</td>
<td>(59)</td>
<td>169</td>
<td>1,210</td>
</tr>
<tr>
<td>20X2</td>
<td>1,210</td>
<td>104</td>
<td>(59)</td>
<td>85</td>
<td>1,340</td>
</tr>
<tr>
<td>20X3</td>
<td>1,340</td>
<td>109</td>
<td>(59)</td>
<td>10</td>
<td>1,400</td>
</tr>
<tr>
<td>20X4</td>
<td>1,400</td>
<td>113</td>
<td>(59)</td>
<td>(9)</td>
<td>1,445</td>
</tr>
<tr>
<td>20X5</td>
<td>1,445</td>
<td>119</td>
<td>(1,309)</td>
<td>255</td>
<td>0</td>
</tr>
</tbody>
</table>

Note that interest income is calculated based on amortised cost and interest received is calculated based on the principal amount. Both of these amounts are the same as those in the previous example.

The required journal entries in 20X1 are ($):

DEBIT Financial asset through other comprehensive income 1,000
CREDIT Cash/bank 1,000
To recognise the financial asset on 1 January 20X1

DEBIT Financial asset through other comprehensive income 210
DEBIT Cash/bank 59
CREDIT Profit or loss (interest income) 100
CREDIT Other comprehensive income 169
To recognise interest income at the effective rate and the change in fair value.

On derecognition of a debt instrument measured at fair value through other comprehensive income, any amounts previously recognised as other comprehensive income are reclassified to profit or loss.

Therefore in the example above, a gain of $255 is recognised in profit or loss on derecognition and a cumulative net gain of $255 (169 + 85 + 10 – 9) is reclassified by ($):

DEBIT Other comprehensive income 255
CREDIT Profit or loss 255

5.2.3 Fair value through other comprehensive income (equity instrument)

Where an entity elects to measure an equity investment at fair value through other comprehensive income, any dividend revenue is recognised in profit or loss.

Other changes, including foreign exchange differences, are recognised in other comprehensive income. On derecognition of an equity investment measured at fair value through other comprehensive income, the cumulative amount recognised in other comprehensive income cannot be reclassified to profit or loss.
Example

Lucky Foods Ltd acquires a listed equity investment on 18 August 20X1 and elected to measure it at fair value through other comprehensive income. The investment cost $1.3 million and Lucky Foods incurred transaction costs of $50,000. At Lucky Food's year-end of 31 January 20X2 the market price of an identical investment is $1.46 million. How is the asset initially and subsequently measured?

Solution

The investment is initially measured at fair value (cost) plus transaction costs because an election has been made to measure equity instruments at FVTOCI. This is recorded by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset 1,350,000</td>
<td>Cash 1,350,000</td>
</tr>
</tbody>
</table>

to record the acquisition of the equity investment and related transaction costs

Subsequently at the year-end, the investment is re-measured to fair value ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset 110,000</td>
<td>Other comprehensive income 110,000</td>
</tr>
</tbody>
</table>

to re-measure the equity investment to fair value

5.2.4 Fair value through profit or loss

All amounts in respect of financial assets classified as measured at fair value through profit or loss are recognised in profit or loss. These amounts include interest or dividend income, foreign exchange differences and any other gains or losses on derecognition.

Example

Firtree Traders Ltd acquired an equity investment on 31 July 20X8 at a cost of $7 million and made no elections regarding its classification. Transaction costs of 0.5% of the cost were incurred. At Firtree Traders' year-end of 31 December 20X8 the market price of an identical investment is $8.2 million. How is the asset initially and subsequently measured?

Solution

As no election has been made, the equity instrument is measured at fair value through profit or loss.

The investment is initially measured at fair value (purchase price) ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset 7,000,000</td>
<td>Cash 7,000,000</td>
</tr>
</tbody>
</table>

to record the acquisition of the equity investment

The transaction costs (0.5% × $7,000,000 = $35,000) are recognised in profit or loss ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit or loss 35,000</td>
<td>Cash 35,000</td>
</tr>
</tbody>
</table>

Subsequently at the year-end, the investment is re-measured to fair value ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset 1,200,000</td>
<td>Profit or loss 1,200,000</td>
</tr>
</tbody>
</table>

to re-measure the equity investment to fair value
5.2.5 Summary of financial asset subsequent measurement rules

<table>
<thead>
<tr>
<th>Description</th>
<th>Amortised cost</th>
<th>FVTOCI (Debt)</th>
<th>FVTOCI (Equity)</th>
<th>FVTPL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest/dividend revenue</td>
<td>Profit or loss</td>
<td>Profit or loss</td>
<td>Profit or loss</td>
<td>Profit or loss</td>
</tr>
<tr>
<td>Impairment losses</td>
<td>Profit or loss</td>
<td>Profit or loss</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Foreign exchange gains/losses</td>
<td>Profit or loss</td>
<td>Profit or loss</td>
<td>OCI</td>
<td>Profit or loss</td>
</tr>
<tr>
<td>Other gains/losses on remeasurement</td>
<td>–</td>
<td>OCI</td>
<td>OCI</td>
<td>Profit or loss</td>
</tr>
<tr>
<td>Gain/loss on derecognition</td>
<td>Profit or loss</td>
<td>Profit or loss with amounts previously recognised in OCI reclassified to profit or loss</td>
<td>Profit or loss but OCI is not reclassified.</td>
<td>Profit or loss</td>
</tr>
</tbody>
</table>

5.3 Reclassification of financial assets

After a reclassification, the measurement rules applicable to the new classification of financial assets are applied prospectively. Accounting procedures on reclassification of financial assets is as follows:

### Reclassification from Amortised cost to FVTPL
- Fair value is determined at the reclassification date
- Any gain or loss arising from a difference between the previous carrying amount and fair value is recognised in profit or loss

### Reclassification from FVTPL to Amortised cost
- Fair value at the date of reclassification becomes the new gross carrying amount.

### Reclassification from Amortised cost to FVTOCI
- Fair value is determined at the reclassification date
- Any gain or loss arising from a difference between the previous carrying amount and fair value is recognised in other comprehensive income

### Reclassification from FVTOCI to Amortised cost
- Asset is transferred at fair value.
- Cumulative gains/losses recognised in OCI are removed from equity and adjusted against fair value of the asset.
- The net effect is that the asset is measured at amortised cost at the reclassification date.

### Reclassification from FVTPL to FVTOCI
- Asset continues to be measured at fair value

### Reclassification from FVTOCI to FVTPL
- Asset continues to be measured at fair value
- Cumulative amounts recognised in profit or loss are reclassified to profit or loss.

SFRS(I) 7 Financial Instruments: Disclosures requires additional disclosures for reclassifications. They relate to the amounts reclassified in and out of each category, the fair values of reclassified assets, fair value gains or losses recognised in the period of reclassification and any new effective interest rate.
5.4 Subsequent measurement of financial liabilities

After initial recognition, financial liabilities are measured at either amortised cost or fair value through profit or loss, depending on their classification.

5.4.1 Amortised cost

Amortised cost is measured in the same way as for financial assets, as detailed above. As before, interest and foreign exchange differences are recognised in profit or loss, as is any gain or loss on derecognition.

**Question 16.6** Measurement

Pacific Hills Ltd issues a bond for $503,778 on 1 January 20X2. No interest is payable on the bond, but it will be held to maturity and redeemed on 31 December 20X4 for $600,000. The bond has not been designated as at fair value through profit or loss.

**Required**

Calculate the charge to profit or loss of Pacific Hills Ltd for the year ended 31 December 20X2 and the bond payable balance outstanding at 31 December 20X2.

**Question 16.7** Finance cost 1

On 1 January 20X3 Jurong Imports Ltd issued $600,000 loan notes at par. Issue costs were $200. The loan notes do not carry interest, but are redeemable at a premium of $152,389 over par on 31 December 20X4. The effective finance cost of the debentures is 12%.

What is the finance cost in respect of the loan notes for the year ended 31 December 20X4?

A $72,000  
B $76,194  
C $80,613  
D $80,640

**Question 16.8** Finance cost 2

On 1 January 20X5, an entity issued a debt instrument with a coupon rate of 3.5% at a par value of $6,000,000. The directly attributable costs of issue were $120,000. The debt instrument is repayable on 31 December 20Y1 at a premium of $1,100,000.

What is the total amount of the finance cost associated with the debt instrument?

A $1,470,000  
B $1,590,000  
C $2,570,000  
D $2,690,000

5.4.2 Fair value through profit or loss

Financial liabilities measured at fair value through profit or loss are remeasured to fair value at each reporting date which changes in fair value recognised in profit or loss; finance costs and exchange differences are also recognised in profit or loss.

Where a financial liability is designated as measured at fair value through profit or loss, the gain or loss is split into constituent parts, each of which is accounted for separately.
### SECTION SUMMARY

- On initial recognition, financial instruments are measured at **fair value**, which is usually transaction price, adjusted for transaction costs (unless classified as FVTPL).
- Subsequent measurement depends on how a financial asset or financial liability is **classified**. In all cases interest/dividends are recognised in profit or loss.
- Remeasurement may be required on **reclassification**.

### 6 Impairment of financial assets

#### SECTION INTRODUCTION

The SFRS(I) 9 impairment requirements are applied to debt instruments measured at amortised cost or fair value through other comprehensive income.

The impairment requirements of SFRS(I) 9 are applied to debt instruments measured at amortised cost or fair value through other comprehensive income plus lease receivables, contract assets, loan commitments not at fair value through profit or loss and financial guarantee contracts not at fair value through profit or loss. They do not apply to equity instruments measured at fair value through other comprehensive income or any financial assets measured at fair value through profit or loss.

#### 6.1 Expected loss model

SFRS(I) 9 applies an 'expected loss' model rather than an 'incurred loss model'. Under this approach, expected credit losses are accounted for from the date that financial instruments are first recognised. The standard prescribes three approaches to impairment:

1. General approach
2. Simplified approach (trade and lease receivables)
3. Purchased (or originated) credit-impaired approach, applicable when a financial asset is credit impaired at the date of initial recognition.
6.2 General approach

The general approach requires that entities recognise 12 month expected credit losses when a financial asset is initially recognised and they must continue to recognise 12 month expected credit losses or, where credit risk has increased significantly since initial recognition, lifetime expected credit losses at subsequent reporting dates.

The model requires that a financial asset is classified as being at one of three stages of impairment:

<table>
<thead>
<tr>
<th>When?</th>
<th>Stage 1</th>
<th>Stage 2</th>
<th>Stage 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit risk not increased significantly since initial recognition</td>
<td>12-month expected credit losses</td>
<td>Lifetime expected credit losses</td>
<td>Lifetime expected credit losses</td>
</tr>
</tbody>
</table>

6.2.1 Stages of the general approach model

Under the general model all financial assets are initially deemed as being at stage 1; at each reporting date, an entity should assess whether stage 2 or 3 has been reached.

**Stage 2**

Stage 2 is reached when credit risk has increased significantly since initial recognition ie there is an increased risk that the borrower will default. This is presumed to occur at the latest when contractual payments are over 30 days past due, however this presumption may be rebutted SFRS(I) 9 Application Guidance provides information that should be considered when assessing whether credit risk has increased significantly. It includes:

(a) Adverse changes in economic, financial or business conditions that affect the borrower
(b) A decline (actual or expected) in the operating results of the borrower
(c) A downgrade (actual or expected) in the borrower's credit rating
(d) A change in the financial instrument's external credit rating
(e) Significant increases in credit risk on other financial instruments of the same borrower

A movement to stage 2 of the model is reversible; if a significant increase in credit risk is no longer evident at a subsequent reporting date, credit losses are measured at a 12-month amount.

**Stage 3**

Stage 3 is reached when there is evidence of impairment. Examples provided within Appendix A of SFRS(I) 9 of evidence of impairment include breach of contract, significant financial difficulty of the borrower and it becoming probable that a borrower will enter bankruptcy.

6.2.2 Expected credit losses

12 month and lifetime expected credit losses are defined as follows:

<table>
<thead>
<tr>
<th>Credit losses recognised</th>
<th>12 month expected credit losses</th>
<th>Lifetime expected credit losses arising from default events that are possible within 12 months of the reporting date.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lifetime expected credit losses</td>
<td>Lifetime expected credit losses arising from possible default events over the expected life of a financial instrument.</td>
<td></td>
</tr>
</tbody>
</table>

Credit losses are measured as:

Present value of cash flows of principal and interest that are contractually due to an entity \( X \)
Present value of cash flows that an entity expects to receive \( X \)
Credit losses \( X \)
The estimation of expected credit losses must reflect:

- **Expected cash flows**, including cash flows expected from collateral that is part of the contractual terms and is not recognised by the lender eg where a loan is secured on an asset, default would result in the sale of the asset and sales proceeds should be included in cash flows that the lender expects to receive. This cash flow is considered regardless of whether default is expected; it may result in the present value of cash flows expected to be received exceeding the amount of the loan, in which case expected credit losses are nil.

- **The time value of money.** An effective interest rate determined at initial recognition should be used, and amounts discounted to the reporting date.

- **An unbiased and probability weighted amount** that is determined by considering a range of possible outcomes. There may be two outcomes (a credit loss occurs or it does not) or there may be several outcomes. Each outcome is probability weighted in order to calculate an expected credit loss.

- **Reasonable and supportable information** available without undue cost or effort at the reporting date about past events, current conditions and future forecasts. Both internal and external information should be considered, including general economic conditions, borrower-specific factors, credit loss experience and internal and external ratings. Inputs and techniques used to determine expected credit losses should be reviewed regularly.

### 6.2.3 Interest receivable

SFRS(I) 9 specifies that interest receivable is calculated:

- Based on the gross carrying amount (ie before credit losses are taken into account) on financial assets at stages 1 and 2 of the general impairment model.

- Based on the net carrying amount (ie after credit losses are taken into account) on financial assets at stage 3 of the general impairment model.

#### Example

On 1 January 20X6, Hartley Florals Ltd (HFL) purchased an investment in a $1,000,000 5% debt instrument. It classified the financial asset as measured at amortised cost. The effective interest rate is 5%. At 1 January 20X6 there was a 4% probability that the counterparty would default on the loan within 12 months, resulting in a 100% loss. At 31 December 20X6, there was assessed to be a 1% probability of default within 12 months, resulting in a 100% loss. At 31 December 20X7, HFL expects the counterparty to breach its loan covenants and the probability of the loan defaulting over the remainder of the term is assessed at 45%. At 31 December 20X8, the counterparty breached its loan covenants and HFL assessed the probability of the loan defaulting over the remainder of the term to be 85%.

What amount of impairment loss and interest revenue are recognised by HFL in each of the years ended 31 December 20X6, 20X7 and 20X8?

#### Solution

**1 January 20X6**

The gross financial asset is $1,000,000 and the impairment allowance is $40,000 (4% × $1,000,000). Therefore the impairment loss recognised immediately is $40,000.

**31 December 20X6**

The gross financial asset is $1,000,000 and the impairment allowance is $10,000 (1% × $1,000,000). Therefore a $30,000 reversal of impairment loss is recognised, giving a net amount for the year of $10,000 ($40,000 – $30,000).
Interest revenue is recognised based on gross carrying amount at $50,000 (5% × $1,000,000)

31 December 20X7

The financial asset moves to stage 2 of the general model, as credit risk has significantly increased.

The gross financial asset is $1,000,000 and the impairment allowance based on lifetime losses is $450,000 (45% × $1,000,000). Therefore a $440,000 ($450,000 – $10,000) impairment loss is recognised.

Interest revenue is recognised based on gross carrying amount at $50,000 (5% × $1,000,000)

31 December 20X8

The financial asset moves to stage 3 of the general model because the breach of loan covenants is evidence of impairment.

The gross financial asset is $1,000,000 and the impairment allowance based on lifetime losses is $850,000 (85% × $1,000,000). Therefore a $400,000 ($850,000 – $450,000) impairment loss is recognised.

Interest revenue is recognised based on net carrying amount at $7,500 (5% × ($1,000,000 – $850,000))

6.2.4 Modifications

If contractual cash flows in relation to a financial asset are modified, the asset may be derecognised and a new financial asset recognised. Where this occurs, the date of modification is treated as the date of initial recognition for the purpose of applying SFRS(I) 9 impairment guidance ie 12-month credit losses are recognised until credit risk is assessed as significantly increased (unless the asset is assessed as credit-impaired at initial recognition – see below).

If a modified financial asset is not derecognised, the financial asset is not automatically considered to have lower credit risk; an assessment should be made as to whether there is a significant increase in credit risk by comparing:

(a) The risk of a default occurring at the reporting date based on the modified terms of the contract, with

(b) The risk of a default occurring at initial recognition based on the original, unmodified contractual terms.

In order for a financial asset to be assessed as reverting to stage 1 after modification, when it was previously assessed as at stage 2, the customer would typically need to demonstrate consistently good payment behaviour over a period of time. One on-time payment after modification does not typically erase a history of missed or incomplete payments.

6.3 Simplified approach for trade and lease receivables

For trade receivables and contract assets that do not have an SFRS(I) 15 financing element the loss allowance is measured at the lifetime expected credit losses, from initial recognition.

A provision matrix may be used to calculate lifetime credit losses. This involves grouping receivables according to historical loss patterns (eg by type of customer or product or by geographical location) and applying a historic provision rate, which may be adjusted to reflect current information.

For other trade receivables and for lease receivables, the entity can choose (as a separate accounting policy for trade receivables and for lease receivables) to apply the general approach or to recognise an allowance for lifetime expected credit losses from initial recognition.
When assessing credit losses, cash flows related to a lease receivable should be discounted at the discount rate used to measure the lease receivable.

Example

Golden Acre Ltd (GAL) has calculated its loss allowance in respect of trade receivables using a probability matrix based on historic observed default rates adjusted for current conditions and forward looking estimates:

<table>
<thead>
<tr>
<th>Expected default rate</th>
<th>Gross carrying amount ($)</th>
<th>Credit loss allowance ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>0.2%</td>
<td>1,230,000</td>
</tr>
<tr>
<td>1 – 30 days past due</td>
<td>2.1%</td>
<td>890,000</td>
</tr>
<tr>
<td>31 – 60 days past due</td>
<td>6.0%</td>
<td>225,000</td>
</tr>
<tr>
<td>61 – 90 days past due</td>
<td>8.6%</td>
<td>130,000</td>
</tr>
<tr>
<td>Over 90 days past due</td>
<td>15.4%</td>
<td>72,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

6.4 Purchased credit-impaired approach

A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have already occurred. When a financial asset is credit-impaired at initial recognition, the SFRS(I) 9 approach to impairment is as follows:

(a) Measure the credit-impaired financial asset at transaction price at initial recognition (without an allowance for expected contractual cash shortfalls that are implicit within the purchase price);

(b) When calculating the effective interest rate, include lifetime credit losses in the estimated cash flows;

(c) Calculate interest revenue based on the net carrying amount at the credit-adjusted effective rate;

(d) Discount expected credit losses using the credit-adjusted effective rate; and

(e) Recognise subsequent changes in expected credit losses in profit or loss.

Example

Hemmens Ltd (HL) acquired a debt instrument on 1 January 20X5 at a cost of $330,580. The $1,000,000 debt instrument had been issued by Woodside Group (WG) on 1 January 20X1. The terms of the instrument had required WG to pay $70,000 interest annually in arrears and repay the principal on 31 December 20X7, however WG had encountered financial difficulties and was unable to pay the interest due on 31 December 20X4.

When HL acquired the instrument, it determined that the loan stock was credit impaired, and estimated that it could expect to receive a single payment of $400,000 on 31 December 20X6. As the debt was credit-impaired at purchase, HL calculated an effective interest rate based on the estimated cash flows of the instrument ie the rate that, when used to discount the $400,000 payment two years after purchase, would give an amount of $330,580 (ie the purchase price). This was 10%.

How is SFRS(I) 9 applied to account for the investment in the debt instrument?
Solution

At 1 January 20X5, HL should recognise the acquisition at cost by ($):

DEBIT Financial asset 330,580
CREDIT Bank 330,580

At 31 December 20X5, HL recognises interest income by ($):

DEBIT Financial asset  (10% × $330,580) 33,058
CREDIT Finance income 33,058

The carrying amount of the debt instrument financial asset is now $363,638

At 31 December 20X6, HL recognises interest revenue and the receipt of payment from WG by ($):

DEBIT Bank 400,000
CREDIT Finance income  (10% × $363,638) 36,362
CREDIT Financial asset 363,638

6.5 Summary of approach

The following summary is taken from the Illustrative Examples to SFRS(I) 9:

Is this financial instrument a purchased or originated credit-impaired financial asset? (Yes)

Is the simplified approach for trade receivables, contract assets and lease receivables applicable? (No)

Does the financial instrument have low credit risk at the reporting date? (Yes)

Has there been a significant increase in credit risk since initial recognition? (No)

Recognise lifetime expected credit losses

And

Is the financial instrument a credit-impaired financial asset? (Yes)

Calculate interest revenue on amortised cost

Is the low credit risk simplification applied? (Yes)

Recognise 12-month expected credit losses and calculate interest revenue on gross carrying amount

Calculate a credit-adjusted effective interest rate and always recognise a loss allowance for changes in lifetime expected credit losses

Calculate interest revenue on the gross carrying amount
6.6 Recognition of credit losses

Impairment losses (and reversals) are recognised in profit or loss. The opposite entry is recognised as follows:

**Financial assets at amortised cost**

The credit entry is made to an allowance account. This is offset against the carrying amount of the financial asset in the statement of financial position so that a net amount is presented. At such time as all or part of a financial asset is considered irrecoverable, a write-off occurs and the allowance is 'used up' by:

- **DEBIT** Allowance
- **CREDIT** Financial asset

**Financial assets at fair value through OCI**

The credit entry is made to an 'accumulated impairment amount' in OCI. The carrying amount of the financial asset is not adjusted in the statement of financial position.

**Loan commitments and financial guarantee contracts**

The credit entry is recorded in a provision account, which is presented as a separate liability necessarily (because no asset is recognised in respect of a loan commitment or financial guarantee contract).

---

**Example**

Jurong Traders Ltd (JTL) acquired a debt instrument for $2,000,000 on 12 November 20X6. The instrument was classified as measured at FVTOCI; it has a contractual term of 10 years, a coupon rate of 6% paid annually in arrears and an effective interest rate of 6%.

On 31 December 20X6, the fair value of the debt instrument decreased to $1,900,000 due to changes in interest rates; there is no significant increase in credit risk at this date. 12 month expected credit losses amount to $60,000.

On 1 January 20X7, JTL decided to sell the debt instrument for its fair value of $1,900,000.

What accounting entries are required to recognise the purchase, impairment and disposal of the debt instrument?

**Solution**

At 12 November 20X6 the acquisition is recognised by ($):

- **DEBIT** Financial asset 2,000,000
- **CREDIT** Bank 2,000,000

At 31 December 20X6 the fair value of the instrument has decreased by $100,000 and 12-month credit losses of $60,000 have been calculated. These are recognised by ($):

- **DEBIT** Impairment loss (SPL) 60,000
- **DEBIT** Other comprehensive income 40,000
- **CREDIT** Financial asset 100,000

The $40,000 entry to other comprehensive income is the net effect of a $100,000 debit to recognise the change in fair value and a $60,000 credit to recognise the allowance for impairment.

At 1 January 20X7, the disposal of the debt instrument is recognised by ($):

- **DEBIT** Bank 1,900,000
- **CREDIT** Financial asset 1,900,000

To derecognise the debt instrument, and

- **DEBIT** Loss (SPL) 40,000
- **CREDIT** Other comprehensive income 40,000

To reclassify amounts recognised in other comprehensive income to profit or loss in accordance with SFRS(I) 9.
SECTION SUMMARY

- SFRS(I) 9 impairment rules apply to debt instruments measured at amortised cost or at fair value through OCI plus lease receivables, contract assets, loan commitments and financial guarantee contracts.
- 12 month expected credit losses are initially recognised on a financial asset; where credit risk is significantly increased at a subsequent reporting date, lifetime expected credit losses are recognised.
- A simplified approach to impairment can be applied to trade and lease receivables.

SFRS(I) 9 provides specific guidance for financial assets that are credit impaired at acquisition.

Impairment losses are recognised in profit or loss; the credit entry may be to an allowance account, other comprehensive income or a provision account depending on the nature of the impaired asset.

7 Embedded derivatives

SECTION INTRODUCTION

Derivatives may be embedded within financial or non-financial host contracts.

As we saw earlier in the chapter, a derivative is a financial instrument or other contract within the scope of SFRS(I) 9 with all three of the following characteristics.

(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract;

(b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) It is settled at a future date.

Examples might include forward contracts to buy currency (where the value of the contract changes in response to the exchange rate), options to buy coffee (where the value of the option changes in response to the price of coffee) or interest rate swaps (where the value of the swap changes in response to changes in interest rates).

Certain contracts that are not themselves derivatives (and may not be financial instruments) include derivative contracts that are ‘embedded’ within them. These non-derivatives are called host contracts.

KEY TERM

An Embedded derivative is a derivative instrument that is combined with a non-derivative host contract to form a single hybrid instrument.
7.1 Examples of host contracts
Possible examples include:
(a) A lease
(b) A debt or equity instrument
(c) An insurance contract
(d) A sale or purchase contract

7.2 Examples of embedded derivatives
Possible examples include:
(a) A term in a lease of retail premises that provides for contingent rentals based on sales:

<table>
<thead>
<tr>
<th>'Host' contract</th>
<th>Contingent rentals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounted for as normal</td>
<td>Treat as derivative, i.e. re-measured to FV with changes recognised in profit or loss</td>
</tr>
</tbody>
</table>

(b) A bond which is redeemable in five years’ time with part of the redemption price being based on the increase in the FTSE ST Indices.

(c) A contract to construct an asset, for a fixed price denominated in foreign currency, with payment receivable in stages on specified dates in the future. The construction contract is a non-derivative contract, but the changes in foreign exchange rate give the embedded derivative.

(d) A contract to purchase a non-current asset in a foreign currency, payable 90 days in the future.

7.3 Accounting treatment of embedded derivatives
Where the host contract is a financial asset within the scope of SFRS(I) 9, the classification and measurement rules of SFRS(I) 9 are applied to the whole contract.

Where the host contract is not a financial asset within the scope of SFRS(I) 9, the embedded derivative should be separated from its host contract and accounted for as a derivative when the following conditions are met.

(a) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract.

The following are examples of embedded derivatives that are considered closely related or not closely related to their host contract:

<table>
<thead>
<tr>
<th>Closely related</th>
<th>Not closely related</th>
</tr>
</thead>
<tbody>
<tr>
<td>A sale, purchase or lease denominated in foreign currency where the currency is:</td>
<td></td>
</tr>
<tr>
<td>• The functional currency of one of the parties to the contract</td>
<td></td>
</tr>
<tr>
<td>• Routinely used in international commerce for that good or service</td>
<td></td>
</tr>
<tr>
<td>• Commonly used in business transactions in the economic environment in which the transaction takes place</td>
<td></td>
</tr>
<tr>
<td>A debt contract with a put option where the option’s exercise price is significantly more than the amortised cost of the debt on the exercise date</td>
<td></td>
</tr>
<tr>
<td>An option to extend the maturity of debt at market rates at the time of extension</td>
<td></td>
</tr>
<tr>
<td>An option to extend the maturity of debt at an interest rate that is not the market rate at the time of extension</td>
<td></td>
</tr>
<tr>
<td>A fixed rate note with an embedded fixed to floating swap</td>
<td></td>
</tr>
<tr>
<td>Equity or commodity indexed principal or interest payments</td>
<td></td>
</tr>
</tbody>
</table>
(b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.

(c) The hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (a derivative embedded in a financial asset or financial liability is not be separated out if the entity holds the combined instrument at fair value through profit or loss).

7.3.1 Decision flowchart

The following decision tree will help you to decide how a contract with an embedded derivative should be accounted for:

Is the host contract a financial asset within the scope of SFRS(I) 9?

Yes → Do not separate out the embedded derivative

No

Is the hybrid instrument measured at fair value through profit or loss?

Yes → Do not separate out the embedded derivative

No

Would it be a derivative if it were a separate instrument?

Yes → Do not separate out the embedded derivative

No

Are its characteristics/risks closely related to those of the host contract?

Yes → Do not separate out the embedded derivative

No → Account separately for the embedded derivative

SECTION SUMMARY

Embedded derivatives are derivative instruments that are embedded within a host contract that may or may not be a financial instrument. An embedded derivative is separated from its host contract for accounting purposes when certain conditions are met.
8 Hedging

SECTION INTRODUCTION
Hedge accounting means designating one or more instruments so that changes in fair values are offset by changes in the fair value or cash flows of another item.

8.1 Introduction

It is common business practice to engage in hedging activities in order to reduce exposure to risk and uncertainty. For example, a Singapore company may have a commitment to pay a certain amount of Malaysian Ringgit to a supplier on a date in the future. There is, however, the risk that the exchange rate of the Singapore dollar will weaken against the Ringgit and so the purchase will cost more. The company can hedge against this risk by entering a forward contract to buy ringgit at an agreed exchange rate on a certain date.

Hedge accounting involves matching any gains or losses on the hedging instrument (the derivative) with gains and losses on the hedged item. These gains and losses are matched either in profit or loss or in other comprehensive income depending on the type of hedge.

The SFRS(I) 9 model for hedge accounting aligns the accounting treatment more closely with the risk management activities of an entity. This combines the following.

(a) A management view, that aims to use information produced internally for risk management purposes, and
(b) An accounting view that seeks to address the risk management issue of the timing of recognition of gains and losses.

8.1.1 Key terms

For accounting purposes, hedging means designating one or more hedging instruments so that their change in fair value is offset, in whole or in part, by the change in the fair value or cash flows of a hedged item.

Hedged item

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be a single item or a group of items and it must be reliably measurable.

Hedging instrument

A hedging instrument may be a derivative or a non-derivative financial asset or liability measured at fair value through profit or loss (other than financial liabilities designated at fair value through profit or loss for which changes in fair value due to credit risk are presented in other comprehensive income).

For the hedge of a foreign currency risk, the foreign currency risk component of a non-derivative financial asset or liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument measured at FVTOCI by election.

8.1.2 Hedge accounting and groups

Both a hedged item and a hedging instrument must generally arise from contracts with external parties. Therefore hedge accounting can usually only be applied to transactions between group entities in the separate financial statements of those entities, and not in the consolidated financial statements.
There are exceptions to this:

(a) Hedge accounting can be reported in the consolidated financial statements of an investment entity, where transactions between the investment entity and subsidiary are not eliminated.

(b) The foreign currency risk of an intragroup monetary item may qualify as a hedged item in consolidated financial statements if it results in an exposure to foreign exchange gains and losses that are not fully eliminated on consolidation eg where the transaction is between entities with different functional currencies.

(c) The foreign currency risk of a highly probable group transaction may qualify as a hedged item in consolidated financial statements if it is in a currency other than the functional currency of the entity and the foreign currency risk will affect profit or loss.

8.2 Types of hedge

The standard identifies three types of hedging relationship.

Before considering each of these in more detail, it is important to realise that hedge accounting is only allowed where strict conditions are met.

8.3 Conditions for hedge accounting

SFRS(I) 9 permits hedge accounting only if:

(a) The hedging relationship consists only of eligible hedging instruments and eligible hedged items, and

(b) At the inception of the hedging relationship there is formal designation and documentation of the relationship as well as the entity’s risk management objective and strategy for undertaking the hedge, and

(c) The following hedge effectiveness criteria are met.

(i) There is an economic relationship between the hedged item and the hedging instrument, ie the hedging instrument and the hedged item have values that generally move in opposite directions because of the same risk, which is the hedged risk.

(ii) The effect of credit risk does not dominate the value changes that result from that economic relationship, ie the gain or loss from credit risk does not frustrate the effect of changes in the underlyings on the value of the hedging instrument or the hedged item, even if those changes were significant.

(iii) The hedge ratio of the hedging relationship (quantity of hedging instrument vs quantity of hedged item) is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

Hedge ratio is defined in SFRS(I) 9 as ‘the relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.’

SFRS(I) 9 requires that the hedge ratio used for accounting purposes is the same as that used for risk management purposes. This ensures that amounts are not manipulated in order to achieve a particular accounting outcome.
Example

Trowbridge Coffee Ltd (TCL) buys coffee in a part-processed state, prior to the milling stage. As a result it pays a discounted price compared to that for fully processed coffee. The price of fully processed coffee on the commodities market is on average 1.7 times the raw material price that TCL pays. Therefore TCL uses a notional 1,000 pounds of forward contract for the commodity to hedge a highly probable forecast purchase of 1,700 pounds of raw material. The hedge ratio is therefore 1 : 1.7.

8.3.1 Rebalancing hedging relationships

Rebalancing refers to adjustments to the designated quantities of the hedged item or the hedging instrument of an already existing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge. This may be achieved by increasing or decreasing the volume of either hedged item or hedging instrument.

The standard requires rebalancing to be undertaken if the risk management objective remains the same, but the hedge effectiveness requirements are no longer met. Where the risk management objective for a hedging relationship has changed, rebalancing does not apply and the hedging relationship must be discontinued.

Example

Continuing with the previous example, the price of coffee on the commodities market decreases to an average 1.5 times the raw material price. The hedge ratio might therefore be reset to 1 : 1.5. The hedging relationship is rebalanced by either:

(a) Increasing the amount of the hedging instrument so that the forward that is part of the hedge is for a notional 1,133 pounds (at a ratio of 1:1.5 to hedge 1,700 pounds, the hedging instrument must be 1,700/1.5 = 1,133 pounds)

(b) Decreasing the amount of the hedged item so that the probable forecast purchase that is part of the hedge is for 1,500 pounds of part-processed coffee (at a ratio of 1: 1.5, if the hedging instrument is for a notional 1,000 pounds, the hedged item must be 1,000 \times 1.5 = 1,500 pounds).

8.4 Accounting treatment

8.4.1 Fair value hedges

In a fair value hedge:

(a) The hedged item is a recognised asset or liability. This is re-measured to fair value at the end of the reporting period and the gain or loss on the hedged item attributable to the hedged risk is recognised in profit or loss.

(b) The hedging instrument is a derivative. The gain or loss resulting from re-measuring the hedging instrument at fair value is also recognised in profit or loss.

(c) If the hedged item is an equity investment measured at fair value through OCI, the gains and losses on the hedged investment and hedging instrument are both recognised in other comprehensive income rather than profit or loss.

(d) If the hedged item is an unrecognised firm commitment, the cumulative change in the fair value of the hedged item after it has been designated as a hedged item is recognised as an asset or liability with a corresponding amount recognised in profit or loss.
Example

A company owns inventories of 20,000 gallons of oil which cost $400,000 on 1 December 20X3.

In order to hedge the fluctuation in the market value of the oil, on 1 December 20X3 the company signs a futures contract to deliver 20,000 gallons of oil on 31 March 20X4 at the futures price of $22.00 per gallon.

The market price of oil on 31 December 20X3 is $23.00 per gallon and the futures price for delivery on 31 March 20X4 is $24.50 per gallon.

Explain the impact of the transactions on the financial statements of the company for the financial year ended 31 December 20X3:

(a) Without hedge accounting
(b) With hedge accounting, assuming the conditions to hedge are met

Solution

The futures contract was intended to protect the company from a fall in oil prices (which would have reduced the profit when the oil was eventually sold). However, oil prices have actually risen, so that the company has made a loss on the futures contract.

(a) Without hedge accounting:

The futures contract is a derivative and therefore must be re-measured to fair value at each reporting date under SFRS(I) 9. The loss on the futures contract is recognised in profit or loss by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Profit or loss (20,000 × (24.5 – 22))</th>
<th>50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Financial liability</td>
<td>50,000</td>
</tr>
</tbody>
</table>

to recognise the change in fair value of the futures contract

(b) With hedge accounting:

The $50,000 loss on the futures contract is recognised in profit or loss as before.

The inventories are remeasured to fair value:

<table>
<thead>
<tr>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value at 31 December 20X3 (20,000 × 23)</td>
</tr>
<tr>
<td>Cost</td>
</tr>
<tr>
<td>Gain</td>
</tr>
</tbody>
</table>

The gain is also recognised in profit or loss by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Inventory</th>
<th>60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Profit or loss</td>
<td>60,000</td>
</tr>
</tbody>
</table>

to recognise the change in fair value of the inventory

The net effect on the profit or loss is a gain of $10,000 compared with a loss of $50,000 without hedging.

Example

On 1 July 20X6, Sentosa Manufacturing (SM) Ltd acquired 10,000 ounces of a material which it held in its inventory. This costs $200 per ounce, resulting in a total of $2 million. SM Ltd was concerned that the price of this inventory would fall. Hence, on 1 July 20X6, it sold 10,000 ounces in the futures market for $210 per ounce for delivery on 30 June 20X7. On 1 July 20X6 the conditions for hedge accounting were all met.
At 31 December 20X6, the end of SM's reporting period, the fair value of the inventory was $220 per ounce while the futures price for 30 June 20X7 delivery was $231 per ounce. On 30 June 20X7 SM sold the inventory and closed out the futures position at the then spot price of $234 per ounce.

Set out the accounting entries in respect of the above transactions.

### Solution

At 31 December 20X6 the increase in the fair value of the inventory was $200,000 (10,000 × ($220 – $200)) and the increase in the futures contract liability was $210,000 (10,000 × ($231 – $210)).

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 December 20X6</td>
<td>Debit Profit or loss</td>
<td>210,000</td>
<td>Credit Financial liability 210,000</td>
</tr>
<tr>
<td></td>
<td>Credit Financial liability to record the loss on the futures contract</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Debit Inventories</td>
<td>200,000</td>
<td>Credit Profit or loss 200,000</td>
</tr>
<tr>
<td></td>
<td>Credit Profit or loss to record the increase in the fair value of the inventories</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

At 30 June 20X7 the increase in the fair value of the inventory was another $140,000 (10,000 × ($234 – $220)) and the increase in the forward contract liability was another $30,000 (10,000 × ($234 – $231)).

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 June 20X7</td>
<td>Debit Profit or loss</td>
<td>30,000</td>
<td>Credit Financial liability 30,000</td>
</tr>
<tr>
<td></td>
<td>Credit Financial liability to record the loss on the forward contract</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Debit Inventories</td>
<td>140,000</td>
<td>Credit Profit or loss 140,000</td>
</tr>
<tr>
<td></td>
<td>Credit Profit or loss to record the increase in the fair value of the inventories</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Debit Profit or loss</td>
<td>2,340,000</td>
<td>Credit Inventories 2,340,000</td>
</tr>
<tr>
<td></td>
<td>Credit Profit or loss to record the inventories now sold</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Debit Cash</td>
<td>2,340,000</td>
<td>Credit Profit or loss – revenue 2,340,000</td>
</tr>
<tr>
<td></td>
<td>Credit Profit or loss – revenue to record the revenue from the sale of inventories</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Debit Financial liability</td>
<td>240,000</td>
<td>Credit Cash 240,000</td>
</tr>
<tr>
<td></td>
<td>Credit Cash to record the settlement of the net balance due on closing the financial liability</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note that the fair value of the material rose over the period meaning that without the forward contract, the profit would have been $340,000 (2,340,000 – 2,000,000). In the light of the rising fair value the trader might in practice have closed out the futures position earlier, rather than waiting until the settlement date.

### 8.4.2 Cash flow hedges

A cash flow hedge involves hedging future cash flows. Initially only the hedging instrument is therefore recognised.

The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised in other comprehensive income and accumulated in equity.

The ineffective portion of the gain or loss on the hedging instrument is recognised in profit or loss.

When a hedging transaction results in the recognition of a non-financial asset or liability, changes in the value of the hedging instrument recognised in other comprehensive income are adjusted against the
carrying value of the asset or liability. In all other cases the amount accumulated in equity is reclassified to profit or loss when the hedged expected future cash flow arises.

For a cash flow hedge, the cash flow hedge reserve in equity is adjusted to the lower of:
(a) Cumulative gain of loss on the hedging instrument from inceptions; and
(b) Cumulative gain or loss on the hedged item from inception

Example

Geylang Electrical (GE) Ltd signs a contract on 1 November 20X1 to purchase an asset on 1 November 20X2 for €60,000,000. GE reports in $ and hedges this transaction by entering into a forward contract to buy €60,000,000 on 1 November 20X2 at $1:€1.5.

Spot and forward exchange rates at the following dates are:

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot</th>
<th>Forward (for delivery on 1.11.X2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.11.X1</td>
<td>$1:€1.45</td>
<td>$1:€1.5</td>
</tr>
<tr>
<td>31.12.X1</td>
<td>$1:€1.20</td>
<td>$1:€1.24</td>
</tr>
<tr>
<td>1.11.X2</td>
<td>$1:€1.0</td>
<td>$1:€1.0 (actual)</td>
</tr>
</tbody>
</table>

Show the journals relating to these transactions at 1 November 20X1, 31 December 20X1 and 1 November 20X2.

You should assume that hedge conditions are met throughout.

Solution

Entries at 1 November 20X1

The value of the forward contract at inception is zero so no entries are recorded (other than any transaction costs), but risk disclosures will be made.

The contractual commitment to buy the asset would be disclosed if material (SFRS(I) 1-16 Property, Plant and Equipment).

Entries at 31 December 20X1

Gain on forward contract:

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of contract at 31.12.X1 (€60,000,000/1.24)</td>
<td>48,387,097</td>
</tr>
<tr>
<td>Value of contract at 1.11.X1 (€60,000,000/1.5)</td>
<td>40,000,000</td>
</tr>
<tr>
<td>Gain on contract (EUR has appreciated against $)</td>
<td>8,387,097</td>
</tr>
</tbody>
</table>

Compare to movement in value of asset (unrecognised):

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in $ cost of asset</td>
<td>$8,620,690</td>
</tr>
<tr>
<td>(€60,000,000/1.20 – €60,000,000/1.45)</td>
<td></td>
</tr>
</tbody>
</table>

As this is higher, there is no ineffectiveness and so all movement on the derivative is included in OCI by ($):

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT Financial asset (Forward a/c)</td>
<td>8,387,097</td>
</tr>
<tr>
<td>CREDIT Other comprehensive income</td>
<td>8,387,097</td>
</tr>
</tbody>
</table>
Entries at 1 November 20X2

**Additional gain on forward contract**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of contract at 1.11.X2 (€60,000,000/1.0)</td>
<td>60,000,000</td>
</tr>
<tr>
<td>Value of contract at 31.12.X1 (€60,000,000/1.24)</td>
<td>48,387,097</td>
</tr>
<tr>
<td>Gain on contract (EUR has appreciated against $)</td>
<td>11,612,903</td>
</tr>
</tbody>
</table>

Compare to movement in value of asset (unrecognised):

Increase in $ cost of asset

\[(€60,000,000/1.0 – €60,000,000/1.2)\] $10,000,000

The cumulative gain on the contract is $60,000,000 – $40,000,000 = $20,000,000. The cumulative loss on the cost of the asset is €60,000,000/1.0 – €60,000,000/1.45 = $18,620,690. As the movement on the contract is more than the movement on the change in cost of the asset, the excess cumulative gain on the contract should be recognised in profit or loss. Therefore the gain to be recognised in OCI this year is 18,620,690 – 8,387,097 =10,233,593.

**Journal entries are in $:**

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset (Forward a/c)</td>
<td></td>
<td>11,612,903</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td></td>
<td>10,233,593</td>
</tr>
<tr>
<td>Profit or loss (20,000,000 – 18,620,690)</td>
<td></td>
<td>1,379,310</td>
</tr>
</tbody>
</table>

**purchase of asset at market price**

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset (€60,000,000/1.0)</td>
<td>Cash</td>
<td>60,000,000</td>
</tr>
</tbody>
</table>

**settlement of forward contract**

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Financial asset (Forward a/c)</td>
<td>20,000,000</td>
</tr>
</tbody>
</table>

**realisation of gain on hedging instrument**

The cumulative gain of $18,620,690 recognised in other comprehensive income is transferred to reduce the initial carrying amount of the asset by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other comprehensive income</td>
<td>Asset</td>
<td>18,620,690</td>
</tr>
</tbody>
</table>

**reclassification of cumulative gain on hedged item from inception**

Therefore the carrying amount of the asset is $41,379,310 (60,000,000 – 18,620,690).

### 8.4.3 Hedge of a net investment in a foreign operation

This type of hedge is relevant to consolidated financial statements where there is a foreign subsidiary. The hedged item is the net investment in a foreign operation and the hedging instrument is usually a foreign currency loan taken to acquire the foreign operation. As identified in section 6.1.1, a non-derivative may be the hedging instrument where the hedged risk is changes in foreign exchange rates.

A net investment in a foreign operation is the amount of the reporting entity’s interest in the net assets of a foreign operation. These net assets are consolidated into the group financial statements, however prior to doing so, they must be translated into the reporting currency. On translation, an exchange difference arises which is recognised in other comprehensive income; this is reclassified to profit or loss on disposal of the operation (see Chapter 29).

Ordinarily, under SFRS(I) 1-21, a foreign currency loan is retranslated at the reporting date (see Chapter 6), and any exchange difference recognised in profit or loss.
Hedge accounting rules change the treatment of the exchange difference on the retranslation of the loan where it is acting as a hedging instrument:

(a) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised in other comprehensive income; and

(b) The ineffective portion is recognised in profit or loss.

Any gain or loss recognised in other comprehensive income is reclassified to profit or loss on the disposal or part disposal of the foreign operation.

SFRS(I) INT 16 Hedges of a Net Investment in a Foreign Operation clarifies the requirements of SFRS(I) 9 by stating that:

1. Hedge accounting only applies to foreign exchange differences arising between the functional currency of the foreign operation and the parent entity's functional currency.

2. The hedging instrument may be held by any member of the group; there is no need for the parent to hold it.

**SECTION SUMMARY**

Hedge accounting means designating one or more instruments so that their change in fair value is offset by the change in fair value or cash flows of another item.

Hedge accounting is permitted in certain circumstances, provided the hedging relationship is clearly defined, measurable and actually meets hedge effectiveness requirements.

There are three types of hedge: fair value hedge; cash flow hedge; hedge of a net investment in a foreign operation.

The accounting treatment of a hedge depends on its type.

**9 Disclosure of financial instruments**

**SECTION INTRODUCTION**

SFRS(I) 7 specifies the disclosures required for financial instruments. It was issued in January 2006 to replace the disclosure requirements of SFRS(I) 1-32.

**9.1 General requirements**

The extent of disclosure required depends on the extent of the entity's use of financial instruments and of its exposure to risk. It adds to the requirements previously in SFRS(I) 1-32 by requiring:

- Enhanced statement of financial position and statement of profit or loss and other comprehensive income disclosures
- Disclosures about an allowance account when one is used to reduce the carrying amount of impaired financial instruments.

The standard requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments, and specifies minimum disclosures about credit risk, liquidity risk and market risk.
9.2 Objective

The objective of SFRS(I) 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) The significance of financial instruments for the entity's financial position and performance
(b) 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 principles in SFRS(I) 7 complement the principles for recognising, measuring and presenting financial assets and financial liabilities in SFRS(I) 1-32 Financial Instruments: Presentation and SFRS(I) 9 Financial Instruments.

9.3 Classes of financial instruments and levels of disclosure

The entity must group financial instruments into classes appropriate to the nature of the information disclosed. An entity must decide in the light of its circumstances how much detail it provides. Sufficient information must be provided to permit reconciliation to the line items presented in the statement of financial position.

9.3.1 Statement of financial position

The following must be disclosed.

(a) **Carrying amount** of financial assets and liabilities by SFRS(I) 9 category and further details of items designated as measured at fair value through profit or loss and equity instruments measured at fair value through other comprehensive income
(b) **Reason for any reclassification** of financial assets
(c) The **carrying amount** of financial assets the entity has **pledged as collateral** for liabilities or contingent liabilities and the associated terms and conditions
(d) The loss allowance in relation to financial assets measured at fair value through other comprehensive income
(e) The **existence of multiple embedded derivatives**, where compound instruments contain these
(f) Defaults and breaches

An entity must also disclose information about rights of offset and related arrangements, including as a minimum:

(a) The gross amounts of financial assets and financial liabilities under an enforceable master netting agreement (ie an agreement whereby a single net settlement of all financial instruments covered by the arrangement may be made) or similar
(b) Amounts offset in accordance with SFRS(I) 1-32 criteria
(c) Net amounts presented in the statement of financial position
(d) Amounts subject to an enforceable master netting agreement not included in (b)
(e) The net amount after deducting (d) from (c)

9.3.2 Statement of profit or loss and other comprehensive income

The entity must disclose the following **items of income, expense, gains or losses**, either on the face of the financial statements or in the notes:

(a) Net gains/losses by SFRS(I) 9 category (broken down as appropriate: eg interest, fair value changes, dividend income)
(b) Interest income/expense
9.3.3 Accounting policies

Entities must disclose in the summary of significant accounting policies the measurement basis used in preparing the financial statements and the other accounting policies that are relevant to an understanding of the financial statements.

9.3.4 Hedge accounting

Disclosures must be made relating to hedge accounting to provide information about:

(a) An entity's risk management strategy and how it is applied to manage risk

(b) How the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows

(c) The effect that hedge accounting has had on the entity's statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity

9.3.5 Fair value

Disclosures relating to fair value are mainly provided in SFRS(I) 13 Fair Value Measurement. SFRS(I) 7 retains the following general requirements.

(a) For each class of financial assets and financial liabilities, an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

(b) In disclosing fair values, an entity shall group financial assets and liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the statement of financial position.

Disclosures of fair value are not required if carrying value is a reasonable approximation to fair value, for example for short-term receivables and payables, or for lease liabilities.

9.4 Nature and extent of risks arising from financial instruments

In undertaking transactions in financial instruments, an entity may assume or transfer to another party one or more of different types of financial risk as defined below. The disclosures required by the standard show the extent to which an entity is exposed to these different types of risk, relating to both recognised and unrecognised financial instruments.

<table>
<thead>
<tr>
<th>Risk Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit risk</td>
<td>The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.</td>
</tr>
<tr>
<td>Currency risk</td>
<td>The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td>The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.</td>
</tr>
<tr>
<td>Liquidity risk</td>
<td>The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.</td>
</tr>
<tr>
<td>Loans payable</td>
<td>Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.</td>
</tr>
<tr>
<td>Market risk</td>
<td>The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.</td>
</tr>
</tbody>
</table>
9.4.1 Qualitative disclosures

For each type of risk arising from financial instruments, an entity must disclose:

(a) The **exposures to risk** and how they arise

(b) Its objectives, policies and processes for managing the risk and the methods used to measure the risk

(c) Any changes in (a) or (b) from the previous period

9.4.2 Quantitative disclosures

For each financial instrument risk, **summary quantitative data** about risk exposure must be disclosed. This should be based on the information provided internally to key management personnel. More information should be provided if this is unrepresentative. Any concentrations of risk if not apparent from the summary or the below should also be given (according to SFRS(I) 7 para 34 (c)).

**Credit risk** disclosures are required to provide:

(a) Information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses, including the methods, assumptions and information used to measure expected credit losses.

(b) Quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of expected credit losses and the reasons for those changes, and

(c) Information about an entity's credit risk exposure (ie the credit risk inherent in an entity's financial assets and commitments to extend credit) including significant credit risk concentrations.

For **liquidity risk** entities must disclose:

(a) A maturity analysis of financial liabilities

(b) A description of the way risk is managed

Disclosures required in connection with **market risk** are:

(a) Sensitivity analysis, showing the effects on profit or loss of changes in each market risk

(b) If the sensitivity analysis reflects interdependencies between risk variables, such as interest rates and exchange rates the method, **assumptions and limitations** must be disclosed

9.5 Capital disclosures

Certain disclosures about **capital** are required. An entity's capital does not relate solely to financial instruments, but has more general relevance. Accordingly, those disclosures are included in SFRS(I) 1-1, rather than in SFRS(I) 7.

Example disclosures can be seen in the Singtel Annual Report 2017 (although you should note that this company did not early-adopt SFRS(I) 9 and so the accounting treatment is based on SFRS(I) 1-39).
Note 25 on pages 197–198 provides numerical disclosures in respect of derivative financial instruments and hedge accounting;

Note 29 on pages 201–203 provides disclosures in respect of unsecured borrowings;

Note 30 on pages 204–205 provides disclosures in respect of secured borrowings;

Note 34 on pages 207–210 provides disclosures in respect of the fair value of financial instruments; and

Note 35 on pages 210–212 provides financial risk management disclosures.


**SECTION SUMMARY**

SFRS(I) 7 specifies the disclosures required for financial instruments. The standard requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments and specifies minimum disclosures about credit risk, liquidity risk and market risk.

**10 Financial instruments and deferred tax**

**SECTION INTRODUCTION**

Financial instruments may give rise to deferred tax.

In Chapter 13, we considered the measurement and recognition of deferred tax. Financial instruments may have a deferred tax impact where the tax base differs from the carrying amount.

(a) The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that flow to the entity when it recovers the carrying amount of the asset. If those economic benefits are not taxable, the tax base of the asset is equal to the carrying amount.

(b) The tax base of a liability is its carrying amount less any amount that will be deductible for tax purposes in respect of that liability in future periods.

The following examples explain and illustrate the application of deferred tax to financial instruments.

**Example**

Somerset Ltd has made a simple loan to another company of $3 million. The repayment of the loan has no tax consequences.

What is the deferred tax effect of making the loan?

**Solution**

The loan has a carrying amount of $3 million; the tax base is equal to the carrying amount because there is no tax consequence of repayment of the loan, which is capital in nature.

Therefore there is no deferred tax effect.
Example

On 1 June 20X2, Queenstown Ltd issues loan notes totalling $2 million, incurring transaction costs of $30,000. The loan notes are repayable on 1 June 20X5 at par and the implicit interest rate is 0.5%. The transaction costs are deducted for tax purposes in the year ended 31 May 20X3. The tax rate is 19%.

What is the deferred tax effect of the loan in the year ended 31 May 20X3?

Solution

The loan is classified as measured at amortised cost, therefore it is initially recognised at proceeds less transaction costs – $1,970,000.

At 31 May 20X3 the carrying amount of the loan is $1,979,850 ($1,970,000 \times 1.005), and $9,850 is recognised as a finance cost.

SFRS(I) 1-12 states that in this situation the taxable temporary difference is the amount of transaction costs already deducted ($30,000) less the cumulative amount amortised to profit or loss ($9,850), therefore $20,150.

Therefore a deferred tax liability of $3,829 ($20,150 \times 19\%) is recognised.

Example

Malacca Ltd acquired an equity instrument for $100,000 on 1 January 20X3. The instrument is measured at fair value through other comprehensive income in accordance with SFRS(I) 9. At 31 December 20X3, the instrument has a fair value of $110,000 and the gain of $10,000 has been recognised as other comprehensive income in accordance with SFRS(I) 9. Malacca pays tax at 19%.

What deferred tax arises in respect of this instrument in the year ended 31 December 20X3?

Solution

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that flow to the entity when it recovers the carrying amount of the asset. The tax base of the instrument is therefore the original cost of $100,000; the carrying amount is the fair value of $110,000.

Therefore there is a taxable temporary difference of $10,000. This gives rise to a deferred tax liability of $1,900 (19\% \times $10,000).

This is recognised by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other comprehensive income</td>
<td>Deferred tax liability</td>
</tr>
<tr>
<td></td>
<td>1,900</td>
</tr>
</tbody>
</table>

The tax resulting from the temporary difference is recognised in other comprehensive income alongside the gain on re-measurement to fair value.

When the financial asset is derecognised, the cumulative gain or loss on re-measurement may not be reclassified to profit or loss. As the asset is derecognised, the temporary difference ceases to exist and the associated deferred tax liability must also be derecognised. As the deferred tax liability is related to the financial asset, it should be treated consistently and is not reclassified through profit or loss.
10.1 Compound instruments

SFRS(I) 1-32 requires that a compound instrument such as convertible loan stock is split at recognition into an equity and a liability component.

As the tax base of the instrument is the proceeds received in most jurisdictions, this gives rise to an immediate taxable temporary difference since the recognised liability is less than proceeds.

SFRS(I) 1-12 takes the view that this temporary difference does not relate to initial recognition and therefore the associated deferred tax liability must be recognised.

The initial recognition of deferred tax is in equity (alongside the equity component to which it relates); subsequent changes in the deferred tax amount are recognised in profit or loss (alongside the finance cost to which it relates).

Example

Sentosa Supplies Ltd issues convertible loan stock on 1 July 20X3 for proceeds of $800,000. No interest is payable. The loan stock has a fixed term of five years and on 30 June 20X8, loan stockholders have the choice to convert their stock to a fixed number of equity shares or redeem for cash.

The following information is relevant:
- The market rate of interest for similar loan stock with no conversion option is 2.71%.
- The imputed interest charges are not tax deductible.
- Conversion of the loan stock has no additional tax consequences.
- The applicable tax rate is 19%.

What entries are made to record the convertible loan stock and associated tax effects at 1 July 20X3 and 30 June 20X4?

Solution

1 July 20X3

The compound instrument is split in accordance with SFRS(I) 1-32 into equity and liability components:

| $ | 
|---|---|
| Proceeds | 800,000 |
| Liability component (800,000/1.02715) | (700,000) |
| Equity component | 100,000 |

This is recognised by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Loan stock (liability)</td>
</tr>
<tr>
<td>800,000</td>
<td>700,000</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>100,000</td>
<td></td>
</tr>
</tbody>
</table>

The tax base of the loan stock is the proceeds of $800,000; the carrying amount is $700,000, and therefore a taxable temporary difference of $100,000 arises. This results in a deferred tax liability of $19,000 ($100,000 \times 19%)..

This is recognised by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>Deferred tax liability</td>
</tr>
<tr>
<td>19,000</td>
<td>19,000</td>
</tr>
</tbody>
</table>

The deferred tax is charged directly to the carrying amount of the equity component of the instrument in accordance with SFRS(I) 1-12.23, giving a net carrying amount of the equity component of $81,000.
30 June 20X4

The liability starts to wind up and a finance cost incurred ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Finance cost ($700,000 × 2.71%)</th>
<th>18,970</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Loan stock (liability)</td>
<td>18,970</td>
</tr>
</tbody>
</table>

The carrying amount of the liability is now $718,970. The tax base remains at $800,000, giving a taxable temporary difference of $81,030 and a deferred tax liability of $15,396 ($81,030 × 19%).

The reduction in the deferred tax liability is recognised by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Deferred tax liability</th>
<th>3,604</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Tax expense (profit or loss)</td>
<td>3,604</td>
</tr>
</tbody>
</table>

The reduction in the deferred tax liability is recognised in profit or loss in accordance with SFRS(l) 1-12.23. As the interest charge is not tax deductible, the tax expense is $3,604 (19% × $18,970) greater than it would have been. Therefore the net effect on tax expense is nil.

SECTION SUMMARY

Deferred tax arises on a financial instrument where the carrying amount differs from the tax base. It also arises in respect of the equity component of a compound instrument.
Chapter Roundup

SFRS(I) 1-32 *Financial Instruments: Presentation*

- Financial assets
  - Contractual obligation to deliver
    - Compound instruments = split account
    - Puttable instruments = equity if conditions met
    - Obligations on liquidation = equity if conditions met
    - Contingent settlement provisions = equity if conditions met
  - Interest, dividends, gains and losses recognised according to classification

- Financial liabilities
  - No contractual obligation to deliver

- Equity
  - No contractual obligation to deliver

Financial Instruments: Presentation
Financial assets

- Recognition: Entity becomes party to contractual provisions of instrument
- Derecognition: Contractual rights expire/transfer risk and rewards
- Classification:
  - Amortised cost
  - Fair value through OCI
  - Fair value through P/L
- Reclassification: If business model changes
- Initial measurement: FV (+ transaction costs if not FVTPL)
- Subsequent measurement: In line with classification
- Impairment: Bases on expected losses:
  - General approach
  - Simplifies approach
  - Credit-impaired assets
- Embedded derivatives
- Deferred tax

Financial liabilities

- Recognition
- Derecognition: Obligation is discharged, cancelled or expires
- Classification:
  - Amortised cost
  - Fair value through P/L
- Reclassification: Never
- Initial measurement: FV (– transaction costs if not FVTPL)
- Subsequent measurement: In line with classification
- Impairment
### SFRS(I) 9 Financial Instruments

#### Conditions
- Eligible hedged items and instruments
- Formal documentation
- Hedge effectiveness criteria met

#### Types
- Fair value hedge
- Cash flow hedge
- Hedge of net investment

#### Accounting treatment

### SFRS(I) 7 Financial Instruments: Disclosures

#### Risks arising from financial instruments

#### Qualitative and quantitative disclosures

- Credit risk
- Liquidity risk
- Market risk

#### Statement of financial position

#### Statement of profit or loss and other comprehensive income

#### Hedge accounting

#### Fair value (also SFRS(I) 13)
Quick Quiz

1. Which three issues are dealt with by SFRS(I) 1-32?
2. What items are not financial instruments according to SFRS(I) 1-32?
3. What is the critical feature used to identify a financial liability?
4. How should compound instruments be presented in the statement of financial position?
5. Define interest rate risk and credit risk.
6. When should a financial asset be derecognised?
7. What is hedging?
8. Name the three types of hedging relationship identified by SFRS(I) 9.
Answers to Quick Quiz

1. Classification; presentation; offsetting of financial instruments
2. Physical assets; prepaid expenses; non-contractual assets or liabilities; contractual rights not involving transfer of financial assets
3. The contractual obligation to deliver cash or another financial asset to the holder
4. Split into liability and equity components.
5. See Section 9.4
6. Financial assets should be derecognised when the rights to the cash flows from the asset expire or where substantially all the risks and rewards of ownership are transferred to another party.
7. Designating one or more hedging instruments so that their change in fair value is an offset, in whole or in part, to the change in fair value or cash flows of a hedged item.
8. Fair value hedge; cash flow hedge; hedge of a net investment in a foreign operation

Answers to Questions

16.1 Qualification

Refer to the definitions of financial assets and liabilities given above.

(a) **Physical assets**: control of these creates an opportunity to generate an inflow of cash or other assets, but it does not give rise to a present right to receive cash or other financial assets.

(b) **Prepaid expenses, etc**: the future economic benefit is the receipt of goods/services rather than the right to receive cash or other financial assets.

16.2 Classification

(i) **Liability**: The preference shares require regular distributions to the holders but more importantly have the liability characteristic of being redeemable. Therefore according to SFRS(I) 1-32 *Financial Instruments: Presentation* they must be classified as debt.

(ii) **Equity**: This transaction is outside the scope of SFRS(I) 1-32. According to SFRS(I) 2 *Share-based Payment* the grant of share options must be recorded as equity in the statement of financial position because it is an equity settled share-based payment. It is an alternative method of payment to cash for the provision of the services of the senior executives.

16.3 Hybrid financial instrument

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of principal $500,000 × 0.747</td>
<td>373,500</td>
</tr>
<tr>
<td>Present value of interest $25,000 × 4.212</td>
<td>105,300</td>
</tr>
<tr>
<td>Liability value</td>
<td>478,800</td>
</tr>
<tr>
<td>Principal amount</td>
<td>500,000</td>
</tr>
<tr>
<td>Equity element</td>
<td>21,200</td>
</tr>
</tbody>
</table>

16.4 Risks and rewards

SFRS(I) 9 includes the following examples in Appendix B, Application Guidance (paragraphs B3.2.4 and B3.2.5).

(a) (i) An unconditional sale of a financial asset

(ii) A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase
16: Financial instruments

(b) (i) A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender’s return

(ii) A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity

16.5 Derecognition

(a) Roldan has transferred the right to receive settlement to the financing company, however it has not transferred the risks of non-payment. Therefore Roldan should not derecognise the receivables balance and should record money received from the financing company as a liability.

(b) The substance of the transaction is that the risks and rewards have not been transferred. In substance the sale proceeds are borrowings secured against the investment. Therefore Sagres should retain the investment in its statement of financial position and recognise the sale proceeds as a liability.

16.6 Measurement

The bond is a ‘deep discount’ bond and is a financial liability of Pacific Hills Ltd. It is measured at amortised cost. Although there is no interest as such, the difference between the initial cost of the bond and the price at which it will be redeemed is a finance cost. This must be allocated over the term of the bond at a constant rate on the carrying amount.

To calculate amortised cost we need to calculate the effective interest rate of the bond:

\[
\frac{600,000}{503,778} = 1.191 \text{ over three years}
\]

To calculate an annual rate, we take the cube root, \((1.191)^{1/3} = 1.06\), so the annual interest rate is 6%.

The charge to profit or loss is $30,226 (503,778 \times 6\%).

The balance outstanding at 31 December 20X2 is $534,004 (503,778 + 30,226).

16.7 Finance cost 1

C The premium on redemption of the preferred shares represents a finance cost. The effective rate of interest must be applied so that the debt is measured at amortised cost (SFRS(I) 9).

At the time of issue, the loan notes are recognised at $599,800 (600,000 – 200) ie fair value less transaction costs.

The finance cost for the year ended 31 December 20X4 is calculated as follows.

<table>
<thead>
<tr>
<th></th>
<th>B/f $</th>
<th>Interest @ 12% $</th>
<th>C/f $</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X3</td>
<td>599,800</td>
<td>71,976</td>
<td>671,776</td>
</tr>
<tr>
<td>20X4</td>
<td>671,776</td>
<td>80,613</td>
<td>752,389</td>
</tr>
</tbody>
</table>

16.8 Finance cost 2

D

\[
\begin{array}{l}
\text{Issue costs} \\
\text{Interest } 6,000,000 \times 3.5\% \times 7 \\
\text{Premium on redemption} \\
\text{Total finance cost}
\end{array}
\]

\[
\begin{array}{l}
120,000 \\
1,470,000 \\
1,100,000 \\
2,690,000
\end{array}
\]
PART E
Accounting for Income
Revenue is the largest figure in many sets of financial statements. SFRS(I) 15 provides a five step approach to recognising revenue from contracts with customers. It also provides application guidance to be used when applying SFRS(I) 15 to different scenarios.

**Topic list**
1. SFRS(I) 15 Revenue from Contracts with Customers
2. Five-step approach
3. Changes in transaction price and contract modifications
4. Contract costs
5. Presentation and disclosure
6. Specific applications
Syllabus Handbook

Learning outcome | Cognitive level
--- | ---
Revenue Recognition | 3
Apply and explain the rules for income recognition and deferral including:
- Combination of contracts
- Unbundling of physical and service elements; and
- Deferred, variable and contingent consideration.

Emerging Trends | 1
Demonstrate awareness of both domestic and international current developments.

ESSENTIAL READING
SFRS(I) 15 *Revenue from Contracts with Customers*, SFRS(I) 15 Illustrative Examples

1 SFRS(I) 15 *Revenue from Contracts with Customers*

SECTION INTRODUCTION
The main issue in accounting for revenue is when to recognise it in the statement of profit or loss. This is covered in SFRS(I) 15 *Revenue from Contracts with Customers*.

Income, as defined by the *Conceptual Framework* document (see Chapter 3 Section 2.5.7 Income), includes both revenues and gains. Revenue is income arising in the ordinary course of an entity's activities and it may be called different names, such as sales, fees, interest, dividends, rent or royalties.

The primary issue in accounting for revenue is determining when it should be recognised in the statement of profit or loss. Accruals accounting is based on the matching of costs with the revenue they generate. It is crucially important under this convention that we can establish the point at which revenue may be recognised so that the correct treatment can be applied to the related costs.

SFRS(I) 15 is one of the newest standards, equivalent to IFRS 15, which replaced IAS 11 *Construction Contracts*, IAS 18 *Revenue Recognition* and a number of related interpretations from 1 January 2018. SFRS(I) 15 deals with the recognition of revenue arising from contracts with customers and its core principle is that revenue is recognised to depict the transfer of goods or services to a customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

The introduction of SFRS(I) 15 has impacted on the timing, measurement, recognition and disclosure of revenue for reporting entities. In a practical sense these impacts have required adjustments to policies, procedures, internal controls and systems and have affected a number of business functions including tax planning, management information, IT systems and investor relations. There is evidence that many Singapore companies have faced challenges in the implementation of the new standard, as described in a 2017 article on the CFO Innovation website 'Many Singapore companies still haven't started adopting FRS 115'. This article refers to FRS 115, which is equivalent to SFRS(I) 15. You can access the article at: [www.cfoinnovation.com/story/12625/many-singapore-companies-still-haven't-started-adopting-frs-115](www.cfoinnovation.com/story/12625/many-singapore-companies-still-haven't-started-adopting-frs-115)

The ASC published an article on the new revenue standard in June 2014 'Revenue recognition: At last a common universal language for top line reporting'. You can access the article on the ASC's website at: [www.asc.gov.sg/Portals/0/attachments/Consultations/2014/Revenue_Article.pdf](www.asc.gov.sg/Portals/0/attachments/Consultations/2014/Revenue_Article.pdf)
1.1 Scope

SFRS(I) 15 applies to all contracts with customers except:

- Leases within the scope of SFRS(I) 16
- Insurance contracts within the scope of SFRS(I) 4 or SFRS(I) 17
- Financial instruments and other contractual rights and obligations within the scope of SFRS(I) 9, SFRS(I) 10, SFRS(I) 11, SFRS(I) 1-27 or SFRS(I) 1-28.
- Non-monetary exchanges between entities in the same line of business

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.

1.2 Definitions

The following definitions provided in Appendix A to SFRS(I) 15 are relevant.

**KEY TERMS**

**INCOME** 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.

**REVENUE** Income arising in the course of an entity's ordinary activities.

**CONTRACT** An agreement between two or more parties that creates enforceable rights and obligations.

**CONTRACT ASSET** An entity's 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 (for example the entity's future performance).

**RECEIVABLE** An entity's right to consideration that is unconditional – ie only the passage of time is required before payment is due.

**CONTRACT LIABILITY** An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

**CUSTOMER** 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.

**PERFORMANCE OBLIGATION** A promise in a contract with a customer to transfer to the customer either:

(a) A good or service (or a bundle of goods or services) that is distinct; or
(b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

**STAND-ALONE SELLING PRICE** The price at which an entity would sell a promised good or service separately to a customer.

**TRANSACTION PRICE** 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.
Revenue does not include sales taxes, value added taxes or goods and service taxes which are only collected for third parties, because these do not represent an economic benefit flowing to the entity.

**SECTION SUMMARY**

SFRS(I) 15 deals with the recognition of revenue arising from contracts with customers.

### 2 Five-step approach

**SECTION INTRODUCTION**

SFRS(I) 15 Revenue from Contracts with Customers prescribes a five-step approach to recognising revenue.

A five step process to revenue recognition is prescribed by SFRS(I) 15:

1. **Identify the contract with the customer**
2. **Identify the separate performance obligations**
3. **Determine the transaction price**
4. **Allocate the transaction price to the performance obligations**
5. **Recognise revenue when (or as) a performance obligation is satisfied**
2.1 Step 1 – Identify the contract with the customer

The contract can be written, verbal or implied by customary business practices and is within the scope of SFRS(I) 15 when all of the following are met:

(a) The parties to the contract have approved the contract and are committed to performing their obligations under the contract

(b) Each party's rights regarding the goods and services to be transferred can be identified

(c) The payment terms regarding the goods and services to be transferred can be identified

(d) The contract has commercial substance

(e) It is probable that the entity will collect the consideration to which it will be entitled, considering the customer's ability and intention to pay that consideration when due. Consideration may amount to less that the price stated in the contract due to variable consideration (see section 2.3).

If these criteria are met, an entity should proceed to step 2 of the five-step process.

If these criteria are not met, an entity should:

(a) Continue to assess a contract to determine whether they are subsequently met, and

(b) Recognise any consideration already received from a customer as a liability, transferring it to revenue only if:

(i) The entity has no remaining obligation to transfer goods or services to the customer and the customer has paid all or substantially all of the consideration due to the entity and it is non-refundable, or

(ii) The contract has been terminated and consideration received is non-refundable, or

(iii) The contract criteria are met.

Question 17.1

Assess whether each of the following contracts meets the SFRS(I) 15 conditions for a contract with a customer and is therefore within the scope of the standard. Where a contract does not meet the conditions, consider how the reporting entity should account for it:

1. Winston Road Limited (WRL) sells 500 electrical components to a customer in a new geographical region for promised consideration of $5,000 due within 60 days. The region in which the customer is based is suffering an economic recession and some political instability and as a result WRL expects to collect 60% of the full $5,000 price stated in the sale contract. Despite this, the management of WRL have proceeded with the sale on the basis that the economy of the region is expected to recover after upcoming political elections, and the sale provides WRL with exposure to other potential customers in the region.

2. Straits Private Clinic (SPC) accepts an emergency admission, being an unconscious individual who has been hurt in a car crash outside the clinic premises. The cost of the initial emergency treatment provided amounts to $8,000 and the individual has not been treated at the clinic previously.

3. Grange Property Limited (GPL) enters into a contract with a customer to sell a retail unit for $3 million on 1 March 20X7. A non-refundable deposit of $200,000 is payable immediately and the remaining amount is payable through a long-term financing agreement between GPL and the customer. If the customer defaults, GPL retains amounts received to date and can repossess the retail unit, but cannot seek further compensation from the customer. The customer obtains control of the unit on 1 March 20X7 and intends to open an electrical goods shop in it; income from the shop's operations will be used to fund repayments to GPL. The customer has little experience in this area and there is a high level of competition from both store-based and web-based electrical goods retailers.
2.1.1 Combining contracts

Contracts are combined as a single contract if one or more of the following apply:
- The contracts are negotiated as a package with a single commercial objective
- Consideration to be paid in one contract depends on the price or performance of the other contract
- The goods or services promised in the contracts are a single performance obligation.

2.2 Step 2 – Identify the separate performance obligations

A contract includes one or more promises to provide goods or services to a customer. Those promises are called performance obligations and may include:
- The sale of goods
- Performance of an agreed task
- Provision of a service
- Construction of an asset
- Granting of a licence

A company should account for a performance obligation contained within a contract separately only if the promised good or service is distinct. A good or service is distinct if:

<table>
<thead>
<tr>
<th>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</th>
<th>AND</th>
<th>The promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e. it is distinct within the context of the contract)</th>
</tr>
</thead>
</table>

Factors that indicate that promises are not separately identifiable include, but are not limited to:

(a) The entity provides a significant service of integrating the good or service with other goods or services promised in the contract.
(b) One or more of the goods or services significantly modifies or customise another good or service promised in the contract.
(c) The goods or services are highly interdependent or highly interrelated.

If promised goods or services are not distinct, the reporting entity should combine promises to deliver goods or services until it identifies a bundle of goods and/or services that are distinct.

Example

Separate performance obligations

Singapore Accounting Solutions (SAS) Ltd has developed a communications software package called Easeaccount. SAS Ltd has entered into a contract with a customer to supply the following:

(a) Licence to use Easeaccount
(b) Installation service. This may require an upgrade to the customer's computer operating system, but the software package does not need to be customised
(c) Technical support for three years
(d) Three years of updates for Easeaccount

SAS Ltd is not the only company able to install Easeaccount, and the technical support can also be provided by other companies. The software can function without the updates and technical support.

**Required**

Explain whether the goods or services provided to the customer are distinct in accordance with SFRS(I) 15 *Revenue from Contracts with Customers*.

**Solution**

Easeaccount was delivered before the other goods or services and remains functional without the updates and the technical support. It may be concluded that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available.

The promises to transfer each good and service to the customer are separately identifiable. In particular, the installation service does not significantly modify the software itself and, as such, the software and the installation service are separate outputs promised by SAS Ltd rather than inputs used to produce a combined output.

In conclusion, the goods and services are distinct and amount to four performance obligations in the contract under SFRS(I) 15.

**Question 17.2**

Identify the separate performance obligations

Cranmer Building Services Limited (CBS) enters into a contract to build an office block for a customer. CBS is responsible for all project management and identifies and provides the following services for the project: procurement of materials, engineering, site clearance, construction, piping and wiring and finishing. It is usual within the construction industry for separate companies to provide some, but not necessarily all, of these services on a project and CBS regularly sells each service on an individual basis.

Identify the performance obligations in the construction contract.

In some cases a series of goods or services are distinct, however because the goods or services are substantially the same and have the same pattern of transfer to the customer, they are accounted for as a single performance obligation.

A series of distinct goods or services has the same pattern of transfer to the customer if:

(a) Each distinct good or service meets the criteria to be a performance obligation satisfied over time (see section 2.5.2), and

(b) The same method would be used to measure progress towards complete satisfaction of the promise to transfer each good or service in the series to the customer (see section 2.5.2).

**Example**

Mopp and Buckitt Ltd (MBL) contracts to provide cleaning service to a customer for a 12 month period. The contract requires MBL employees to clean the customer's premises once weekly.

The cleaning services provided each week are distinct from the services provided in other weeks, however the promise to provide cleaning services is considered to be a single performance obligation because the service provided weekly is substantially the same and the pattern of transfer of services to the customer is the same.
2.3 Step 3 – Determine the transaction price

The transaction price is the amount of consideration a company expects to be entitled to from the customer in exchange for transferring goods or services. It excludes amounts collected on behalf of third parties eg sales tax. It may be affected by the nature, timing and amount of consideration and requires consideration of significant financing components, amounts payable to the customer, non-cash amounts, refund liabilities and variable consideration.

**Significant financing components**

The timing of contract payments may provide either the customer or the selling entity with a significant benefit of financing the transfer of goods/services. For example:

(a) If the selling entity provides a customer with an extended credit period, it may be providing a significant benefit of financing in which case part of the contracted price is deemed to be interest income to the selling entity.

(b) If the selling entity receives cash significantly before transferring goods or services, it may be receiving the benefit of financing and must account for interest payable to the customer.

In order to assess whether there is a financing component to a transaction and whether it is significant, a selling entity should consider:

(a) The difference between promised consideration and the cash selling price of promised goods or services; and

(b) The effect of the length of time between payment of consideration and transfer of goods/services and the prevailing interest rates in the relevant markets.

Where there is a significant financing component to a transaction, the transaction price for the purpose of recognising revenue should reflect the cash selling price at the point in time when control of the goods/services is transferred. The difference between this amount and the promised consideration is the financing component, recognised as interest.

A discount rate is attributed to the financing component and this must reflect the credit characteristics of the party receiving the financing and any security provided. This may be calculated by discounting the promised consideration to the transaction price (the cash selling price) over the period between the cash settlement date and the date on which revenue is recognised (ie when goods or services are transferred).

No adjustment for a significant financing component is required where the period between the transfer of promised goods or services and the cash settlement date is 12 months or less. This is referred to as a ‘practical expedient’.

**Example**

Raygill Manufacturing Limited (RML) enters into a contract to sell an item of machinery to a customer on 1 June 20X6. Control of the machine will transfer in two years’ time on 31 May 20X8 and the customer may choose to pay either $10,000 on 1 June 20X6 or $12,000 on 31 May 20X8. The customer chooses to pay $10,000 on 1 June 20X6. RML’s incremental borrowing rate is 9%

What journals are required to record the transaction in the years ended 31 May 20X7 and 31 May 20X8?

**Solution**

The $10,000 received on 1 June 20X6 is recognised as a contract liability (until such time as the performance obligation is satisfied by transferring the machine to the customer) by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Cash</th>
<th>10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Contract liability</td>
<td>10,000</td>
</tr>
</tbody>
</table>
In the year ended 31 May 20X7, the discount is unwound by $900 (9% × 10,000).

This is recognised by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Finance cost</th>
<th>900</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Contract liability</td>
<td>900</td>
</tr>
</tbody>
</table>

To unwind one year's discount.

In the year ended 31 May 20X8, the discount is unwound by $981 (9% × 10,900).

This is recognised by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Finance cost</th>
<th>981</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Contract liability</td>
<td>981</td>
</tr>
</tbody>
</table>

To unwind one year's discount.

At 31 May 20X8 the machine is transferred to the customer and the contract liability is transferred to be revenue by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Contract liability</th>
<th>11,881</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Revenue</td>
<td>11,881</td>
</tr>
</tbody>
</table>

Question 17.3 Significant financing component

Orchard Furniture Ltd provides customers with three years' ‘interest free’ credit. On 31 December 20X3 the company made sales of $1,500,000, transferring the goods immediately with all customers accepting the credit facility. An imputed rate of interest of 5% is established.

What journals are required to record the transaction in the years ended 31 December 20X3 and 20X4?

Amounts payable to the customer

Amounts payable to the customer within a sale contract may include refunds and rebates as well as credits, coupons and vouchers. These are accounted for as a reduction in the transaction price unless payment is in exchange for a good or service received from the customer. In that case the treatment of the payment to the customer depends on the fair value of goods and services provided by the customer, as the following example illustrates.

Example

Kiff Bay Limited (KBL) sells goods to Zeus Processing Limited (ZPL) for $50,000; the sale contract requires that KBL pays $10,000 to ZPL.

<table>
<thead>
<tr>
<th>If ZPL does not provide goods or services to KBL in exchange for the $10,000</th>
<th>KBL recognises revenue of $40,000 ($50,000 – 10,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>If ZPL provides goods or services to KBL with a fair value of $10,000 (or more)</td>
<td>KBL recognises a purchase of $10,000 and revenue of $50,000</td>
</tr>
<tr>
<td>If ZPL provides goods or services to KBL with a fair value of $7,000 (ie less than $10,000)</td>
<td>KBL recognises a purchase of $7,000 and revenue of $47,000 ($50,000 – 3,000 excess payment)</td>
</tr>
<tr>
<td>If ZPL provides goods or services to KBL and the fair value cannot be reliably estimated</td>
<td>KBL recognises revenue of $40,000 ($50,000 – 10,000)</td>
</tr>
</tbody>
</table>
A reduction in the transaction price is recognised at the later of:

(a) The date on which revenue is recognised; and

(b) The date on which the selling entity pays or promises to pay an amount to the customer (even if payment is conditional upon a future event).

**Non-cash consideration**

Non-cash consideration is measured at fair value. If this cannot be estimated, the consideration is measured by reference to the standalone selling prices of goods or services promised to the customer.

**Refund liabilities**

If an entity expects a customer to return goods and be entitled to a refund (in the form of cash, a credit note or alternative goods), it should not recognise revenue (or a cost of sales) in respect of those goods. Instead a refund liability is recognised and a corresponding asset, which represents items expected to be returned.

**Variable consideration**

Variable consideration may include performance bonuses, incentives, contingent payments and discounts and may increase or decrease transaction price.

Variable consideration is included in the transaction price only to the extent that it is highly probable that a significant amount will not be reversed when any uncertainty associated with the variable consideration is resolved. When assessing the probability of reversal, the selling entity should consider the likelihood of reversal and the magnitude of it. The following may increase the likelihood/magnitude of reversal:

- The amount of consideration is highly susceptible to factors outside the selling entity's influence eg weather conditions
- The uncertainty about consideration is not expected to be resolved for an extended period of time
- The selling entity's experience with similar types of contract is limited or has limited predictive value
- The entity has a practice of offering a wide range of price concessions or changing payment terms and conditions of similar contracts in similar circumstances
- The contract has a large number and wide range of possible consideration amounts

Where variable consideration is included in transaction price, it should be measured at:

- An expected value (ie the sum of probability weighted amounts in a range of possible outcomes); or
- The single most likely amount (ie the single most likely amount in a range of possible consideration amounts).

The chosen approach to measurement should be that which is expected to better predict consideration; the expected value approach is appropriate if the selling entity has a large number of contracts with similar characteristics; the single most likely outcome approach is appropriate if a contract has only two possible outcomes, for example a bonus payment is made or it is not.

Variable consideration should be reassessed at each reporting date for on-going contracts and the estimated transaction price updated. The method applied to measure variable consideration (expected values or single most likely amount) should be applied consistently over a contract. The accounting treatment applied when there is a change in transaction price is considered in section 3 of this chapter.
Example

ADF Ltd supplies tablet computers to large businesses. On 1 July 20X5, ADF Ltd entered into a contract with a customer, under which the customer would purchase tablets at $600 per unit. The contract states that if the customer purchases more than 800 tablets in a year, the price per unit is reduced retrospectively to $520 per unit. ADF Ltd's period end is 30 June.

(a) As at 30 September 20X5, the customer had bought 105 tablets from ADF Ltd. ADF Ltd therefore estimated that the customer's purchases would not exceed 800 in the year to 30 June 20X6, and it would therefore not be entitled to the volume discount.

(b) During the quarter ended 31 December 20X5, the customer expanded rapidly as a result of a substantial acquisition, and purchased an additional 500 tablets from ADF Ltd. ADF Ltd then estimated that the customer's purchases would exceed the threshold for the volume discount in the year to 30 June 20X6.

Required

Calculate the revenue that ADF Ltd should recognise in:

(a) The quarter ended 30 September 20X5
(b) The quarter ended 31 December 20X5

Solution

(a) At 30 September 20X5, based on current level of purchases, ADF Ltd should conclude that when the total number of purchases by the customer for the year ended 31 June 20X6 is known, it will not exceed 800.

Therefore revenue is $600 \times 105 = $63,000

(b) At 31 December 20X5 the customer's purchasing pattern has changed and ADF Ltd can therefore legitimately conclude that the threshold for the volume discount will be exceeded in the year. In this quarter revenue is therefore recognised of:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales in quarter (500 \times $520)</td>
<td>$260,000</td>
</tr>
<tr>
<td>Adjustment for previous quarter's sales (105 \times ($600 – $520))</td>
<td>($8,400)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$251,600</strong></td>
</tr>
</tbody>
</table>

Question 17.4

On 14 February 20X7, Bay Glass Limited (BGL) contracts with a customer to deliver a large number of custom-made glass panes for use in the remodelling of the customer's head office. The price in the contract is $230,000 and the terms state that if the glass panes are delivered by 31 March 20X7, a $20,000 bonus will be payable to BGL by the customer. BGL expects that there is a 75% chance that the panes will be delivered by the required date.

What is the transaction price?
2.4 Step 4 – Allocate the transaction price to the performance obligations

Where a contract contains more than one distinct performance obligation a company should allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each performance obligation as at the inception of the contract.

Therefore, if any entity sells a bundle of goods and/or services which it also supplies unbundled, the separate performance obligations in the contract should be priced in the same proportion as the unbundled prices.

Question 17.5 Allocation of transaction price to performance obligations

Kerrigan Telecommunications Limited (KTL) enters a contract with a customer on 12 September 20X7 to provide a mobile phone handset, insurance against loss or damage to the phone for two years and a combined data and calls package for two years. The total price of the contract is $1,800, payable in monthly instalments of $75 over two years. The standalone selling prices of each element of the contract are:

<table>
<thead>
<tr>
<th>Element</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Handset</td>
<td>$850</td>
</tr>
<tr>
<td>Insurance</td>
<td>$50 per annum</td>
</tr>
<tr>
<td>Data and calls package</td>
<td>$525 per annum</td>
</tr>
</tbody>
</table>

What transaction price is allocated to each performance obligation?

2.4.1 Standalone selling price

If the good or service is not sold separately and a standalone selling price is not observable, the selling entity should estimate its stand-alone selling price using a suitable method such as:

- **An adjusted market approach**: estimating the price that a customer would be willing to pay in the market in which the entity operates
- **Expected cost plus margin approach**: forecasting expected costs of satisfying a performance obligation and adding an appropriate margin
- **Residual approach**: estimating the standalone selling price by deducting the sum of observable standalone selling prices of other performance obligations from the transaction price.

The residual approach is only appropriate if the entity sells the same good or service to different customers at a wide range of prices or the entity has not yet established a price for the goods or service and it has not yet been sold on a stand-alone basis.

2.4.2 Allocation of a discount

Where the transaction price for a bundle of goods/services is less than the sum of standalone prices of the same goods/services, a contract contains a discount.

The discount should be allocated proportionately to all performance obligations in the contract on the basis of standalone selling prices (as in the example above) unless there is evidence that it only relates to certain performance obligations within the contract. This is the case if:

(a) The entity regularly sells each distinct good or service (or bundle of distinct goods or services) in the contract on a standalone basis, and

(b) The entity regularly sells on a standalone basis a bundle of some of those distinct goods or services at a discount to the standalone selling prices of the goods/services in the bundle, and

(c) The discount attributable to the bundle of goods or services in (b) is substantially the same as the discount in the contract and an analysis of the goods or services in the bundle provides observable evidence of the performance obligation to which the entire discount belongs.
Example

Mandai Training Ltd (MTL) publishes post-graduate training materials and provides training courses. It regularly sells business studies text books, revision packs and revision courses at standalone selling prices of $120, $80 and $250 respectively. The company also offers a special 'revision deal', selling a revision pack and a revision course for a special discounted price of $300.

A corporate customer enters a contract with MTL to provide text books, revision packs and revision courses to 10 apprentice employees at a cost of $420 per person.

Required

Explain how the total transaction price of $4,200 is allocated to the performance obligations within the contract.

Solution

The sum of the standalone prices of a book, revision pack and revision course is $450 (120 + 80 + 250). Therefore a discount of $30 is offered to the customer in the contract.

The sum of the standalone prices of a revision pack and a revision course is $330 (80 + 250); these are regularly sold together as a ‘revision deal’ at a price of $300, being a $30 discount on standalone prices.

There is evidence that the $30 discount in the contract with the corporate customer relates only to the revision pack and revision course because:

- MTL regularly sells books, revision packs and revision courses on a standalone basis.
- MTL regularly sells revision packs and revision courses as a discounted bundle called the ‘revision deal’.
- The discount attributable to a ‘revision deal’ is the same as the discount in the contract.

Therefore the total $4,200 ($420 \times 10) contract price is attributable to each performance obligation as follows:

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Text books (standalone selling price – no discount)</td>
<td>$120 \times 10 = 1,200</td>
</tr>
<tr>
<td>Revision packs</td>
<td>\frac{80}{330} \times 300 \times 10 = 727</td>
</tr>
<tr>
<td>Revision courses</td>
<td>\frac{250}{330} \times 300 \times 10 = 2,273</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4,200</strong></td>
</tr>
</tbody>
</table>

2.4.3 Allocation of variable consideration

Variable consideration such as a performance bonus may be attributable to all performance obligations within a contract or only specific performance obligations.

Variable consideration is allocated to a single performance obligation:

- If the terms of the variable payment relate specifically to that performance obligation; and
- If doing so is consistent with the objective of allocating the selling price to each performance obligation to reflect the consideration that the selling entity expects to be entitled to for satisfying that performance obligation.
2.5 Step 5 – Recognise revenue when a performance obligation is satisfied

A company recognises revenue when it satisfies a performance obligation by transferring control of the promised good or service to the customer. A performance obligation can be satisfied:

- At a single point in time; or
- Over time.

A contract may contain some performance obligations that are satisfied at a single point in time and some that are satisfied over time.

2.5.1 Performance obligation satisfied at a single point in time

To determine when control transfers and so revenue is recognised, an entity should consider the following indicators:

- The entity has a present right to payment for the asset
- The entity has transferred legal title to the asset
- The entity has transferred physical possession of the asset
- The entity has transferred the significant risk and reward of ownership to the customer
- The customer has accepted the asset

SFRS(I) 15 does not require all of these indicators to be satisfied, nor does it place more weight on one indicator than another.

2.5.2 Performance obligation satisfied over time

A performance obligation must meet one of three SFRS(I) 15 criteria in order to be considered a performance obligation satisfied over time:

- Customer simultaneously receives and consumes the benefits as the performance takes place
- Entity’s performance creates or enhances an asset and the customer controls the asset as it is created or enhanced
- 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

Eg contract to provide cleaning services
Eg contract to redecorate a customer’s building
Eg contract to construct a property for a customer

An entity must be able to reasonably measure the outcome of a performance obligation satisfied over time before the related revenue can be recognised.

Where a performance obligation is satisfied over time and the outcome can be reasonably measured, revenue is recognised based on the measurement of progress towards complete satisfaction of the performance obligation.

Appropriate measurement methods include:

- Output methods (such as units produced, contract milestones or surveys of work performed)
- Input methods (such as costs incurred, labour or machine hours worked or time elapsed)
A single method should be applied consistently when measuring the progress of a single performance obligation.

In some circumstances, such as in the early stages of a contract, it may not be possible to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred. In these circumstances, revenue is recognised only to the extent of costs incurred.

Example

Bundled Transaction

On 1 January 20X4, a customer enters into a 12-month 'pay monthly' contract for a mobile phone. The contract is with Asiafone Ltd, and terms of the plan are:

(a) The customer receives a free handset on 1 January 20X4
(b) The customer pays a monthly fee of $200, (billed on the last day of the month) which includes unlimited free minutes

The same handset may be purchased from Asiafone Ltd for $500 without the payment plan. The same payment plan without the handset may be purchased for $175 per month.

Asiafone Ltd's year-end is 31 July 20X4.

Required

Explain how Asiafone Ltd should recognise revenue from this contract in accordance with SFRS(I) 15 Revenue from Contracts with Customers. Your answer should include journal entries:

(a) On 1 January 20X4
(b) On 31 January 20X4

Solution

The SFRS(I) 15 five step approach should be used:

| 1 Identify the contract with a customer | Asiafone Ltd has a 12 month contract with the customer. |
| 2 Identify the separate performance obligations in the contract | There are two performance obligations: the obligation to deliver a handset the obligation to provide network services for 12 months. Note these are distinct performance obligations since each could be provided separately. |
| 3 Determine the transaction price | 12 months × $200 = $2,400 |
| 4 Allocate the transaction price to the separate performance obligations in the contract. | $2,400 is allocated to the two performance obligations in proportion to the stand-alone selling price at the contract inception of each performance obligation |

<table>
<thead>
<tr>
<th>Obligation</th>
<th>Stand-alone price ($)</th>
<th>%</th>
<th>Allocation of revenue ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Handset</td>
<td>500</td>
<td>19.2</td>
<td>460.80</td>
</tr>
<tr>
<td>Services (12 × 175)</td>
<td>2,100</td>
<td>80.8</td>
<td>1,939.20</td>
</tr>
</tbody>
</table>

| 5 Recognise revenue when (or as) the entity satisfies a performance obligation | 1. When the handset is provided to the customer on 1 January 20X4 it should recognise the related revenue by ($) |

| DEBIT | Receivable (unbilled revenue) 460.80 |
| CREDIT | Revenue 460.80 |
2. As the network services are provided to the customer, the related revenue is recognised. This is likely to be on a monthly basis as the customer is billed. Therefore on 31 January 20X4 (in $):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivable</td>
<td>Revenue $(1,939.20/12m)</td>
</tr>
<tr>
<td></td>
<td>Receivable (unbilled revenue) $(460.80/12m)</td>
</tr>
</tbody>
</table>

### Example

**Performance obligations satisfied over time**

TTT Ltd starts a contract to construct an office block for a customer on 1 January 20X5, and estimates that it will be completed by 31 December 20X6. The contract price is $15,000,000 and in the first year, to 31 December 20X5:

(a) Costs incurred amounted to $6,000,000.

(b) Half the work on the contract was completed.

(c) Certificates of work completed have been issued, to the value of $7,500,000.

(d) It is estimated with reasonable certainty that further costs to completion in 20X6 will be $6,000,000.

What is the contract profit in 20X5, and what entries would be made for the contract at 31 December 20X5?

### Solution

The SFRS(I) 15 five step approach should be used:

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Identify the contract with a customer</td>
<td>TTT Ltd has a contract with the customer to build an office block.</td>
</tr>
<tr>
<td>2</td>
<td>Identify the separate performance obligations in the contract</td>
<td>There is one performance obligations being the construction of the tower.</td>
</tr>
<tr>
<td>3</td>
<td>Determine the transaction price</td>
<td>The transaction price is fixed at $15 million.</td>
</tr>
<tr>
<td>4</td>
<td>Allocate the transaction price to the separate performance obligations in the contract</td>
<td>The full $15million is allocated to the construction of the tower.</td>
</tr>
<tr>
<td>5</td>
<td>Recognise revenue when (or as) the entity satisfies a performance obligation</td>
<td>This is a performance obligation that is satisfied over time. TTT Ltd is carrying out work for the benefit of a customer rather than creating an asset for its own use and it has an enforceable right to payment for work completed to date. This is evidenced by the fact that certificates of work completed to date have been issued. The amount of payment that TTT Ltd is entitled to corresponds to the amount of performance completed to date, measured using an appropriate method. Here the 'output' method reveals work certified to be 50% of the contract price and therefore the performance obligation is 50% complete. The 'input' method reveals costs incurred to date to be...</td>
</tr>
</tbody>
</table>
50% of total expected costs and therefore the performance obligation is 50% complete.
Therefore regardless of which measurement method used the contract is 50% complete and therefore 50% of the $15m contract price is recognised as revenue, being $7.5million.

SECTION SUMMARY
A five-step approach is taken to recognising revenue:
1. Identify the contract with the customer
2. Identify the separate performance obligations
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognise revenue when (or as) a performance obligation is satisfied

3 Changes in transaction price and contract modifications

SECTION INTRODUCTION
The transaction price of a contract as originally measured may change or the scope and/or price of a contract may be modified before it is concluded.

3.1 Changes in transaction price
The transaction price of some contracts may change over time, without the terms of the contract being modified. This is the case, for example where there is variable consideration and estimations that were previously used to measure the transaction price change.

If the transaction price changes after the inception of the contract:

1. The amount of the change is allocated to the performance obligations within the contract on the same basis as the original transaction price was allocated (i.e. based on standalone selling prices at the inception of the contract).
   If the change in transaction price relates specifically to one (or more, but not all) performance obligations within the contract, and the objective of allocating the transaction price to performance obligations to reflect expected consideration is met, the change in the transaction price may be allocated to one (or more, but not all) performance obligations.

2. If any of the performance obligations to which a change in price has been allocated have been satisfied, the relevant increase or decrease in revenue is recognised in the reporting period in which the transaction price changes.

3. The amount of a change in price allocated to unsatisfied performance obligations is recognised on the same basis as the original transaction price that was allocated to them i.e. at a single point in time or over time as performance obligations are satisfied.

Where the transaction price changes after a contract modification, specific rules apply. These are considered in section 3.2.1 below.
### 3.2 Contract modifications

A contract modification is a change in the scope and/or price of a contract, that is approved by both parties to the contract. If a modification is not approved by both parties, SFRS(I) 15 continues to be applied to the original contract.

Where a modification is approved by both parties, it may be accounted for as a separate contract:

**Diagram:**

- Does the scope of the contract increase because of the addition of distinct promised goods or services?  
  - Yes
  - Does the contract price increase by an amount that reflects the standalone selling prices of additional promised goods or services?  
    - Yes
      - Account for modification as a separate contract
    - No
      - Do not account for modification as a separate contract
  - No

If a contract modification is not accounted for as a separate contract, it is accounted for as:

1. **A replacement of the original contract** with a new contract, if the remaining goods/services are distinct from those transferred on or before the date of the modification.
   - In this case, the consideration to be allocated to the remaining performance obligation(s) is:
     
     \[
     \text{Consideration that was included in original transaction price but has not been recognised as revenue} + \text{Consideration promised as part of contract modification}
     \]

2. **A continuation of the original contract** if the remaining goods/services are not distinct from those transferred on or before the date of the modification and therefore form part of a single performance obligation that is partially satisfied at the modification date.
   - The effect of the contract modification on transaction price/progress towards satisfaction is recognised as an increase or decrease to revenue at the date of the modification.

3. **A combination** of both of the above.

### Example

Trainor Botanicals Limited (TBL) entered into a contract with a customer on 1 October 20X4 to deliver a floral display to a customer to decorate their reception area every week for three years. The contract price for each year of service was $8,000, which reflected the standalone selling price of providing the service. At 30 September 20X6 the contract was modified with new terms as follows:
(a) The price for the third year was reduced to $7,000 (which reflected the new standalone selling price of the service).

(a) The contract was extended for an additional two years with the price for each additional year being $5,500.

TBL’s accounting year end is 30 September.

Explain what amounts are recognised as revenue by TBL over the contract.

Solution

In the years ended 30 September 20X5 and 20X6 the original contract applies. Although each week’s floral display is a distinct good, the contract is accounted for as a single performance obligation because the series of goods in the contract are substantially the same and have the same pattern of transfer.

Total transaction price is $24,000 ($8,000 $3), which reflects the standalone selling price of providing the service. Revenue is recognised as the contract progresses and therefore TBL recognises revenue of $8,000 in each of these years (52/156 weeks $24,000).

At 30 September 20X6 the contract is modified. The modification:

• Does increase the scope of the contract (as it extends the term by two years)
• Does not increase the price by an amount that reflects the standalone selling price of additional services provided (the total price for the third to fifth years is $18,000 (7,000 + 5,500 + 5,500), and the standalone selling price is $21,000 (7,000 $3).

Therefore the modification is not accounted for as a separate contract.

As deliveries of floral displays after modification are distinct from those before, the original contract is deemed to be replaced by a new contract.

The new contract has a transaction price of $18,000 (7,000 + 5,500 + 5,500) and TBL should recognise revenue in each of the three years of $6,000 (52/156 weeks $18,000).

3.2.1 Transaction price changes after contract modification

Where the transaction price changes after a contract modification as a result of variable consideration (and a separate contract is not accounted for at modification):

If the variable consideration was promised before the contract modification and modification accounted for as a termination of old contract and creation of a new contract

Change in price is allocated to performance obligations in original contract

Modification accounted for as continuation of original contract or combination of termination/continuation

Change in price is allocated to performance obligations in modified contract.
Example

Smeaton Components Limited (SCL) contracts with a customer on 1 May 20X6 to provide two components: SS1 and NS4 on 1 July 20X6 and 31 January 20X7 respectively. The transaction price is $2,800, which includes $400 variable consideration.

On 30 September 20X6, after delivery of SS1, the contract is modified to include delivery of component ES9 on 31 May 20X7, and the price of the contract is increased by $800.

On 31 December 20X6, the amount of variable consideration that SCL expects to be entitled to is increased to $600.

The standalone selling prices of the components throughout the contract term are: SS1 $1,500, NS4 $1,500, ES9 $1,500.

Explain what amounts are recognised as revenue by SCL on delivery of each component.

Solution

Total transaction price in the original contract is $2,800. As the standalone selling prices of SS1 and NS4 are equal, revenue of $1,400 \(\frac{1}{2} \times 2,800\) is recognised by SCL on delivery of SS1 on 1 July 20X6.

At 30 September 20X6 the contract is modified. The modification:

(a) Does increase the scope of the contract (as an extra component, ES9 is promised)

(b) Does not increase the price by an amount that reflects the standalone selling price of the additional component

Therefore the modification is not accounted for as a separate contract.

The promises to deliver NS4 and ES9 are distinct from the promise fulfilled before the modification date and therefore the original contract is deemed to be replaced by a new contract.

The transaction price of the new contract is $2,200 ($1,400 original transaction price not yet recognised + $800 additional price due to modification), and this is allocated equally between NS4 and ES9, based on the fact that their standalone selling prices are equal.

The transaction price changes on 1 December 20X6 (before delivery of either NS4 or ES9) due to a $200 increase in variable consideration.

The variable consideration was promised before the contract modification and the modification was accounted for as a termination of old contract and creation of a new contract, therefore the variable consideration is allocated to performance obligations in the original contract.

As the original transaction price was allocated equally between SS1 and NS4, the additional $200 is allocated equally.

SS1 has already been delivered and therefore the additional revenue in respect of this is recognised immediately.

The additional $100 revenue in respect of NS4 is deemed to be part of the outstanding transaction price at modification date. Therefore the transaction price of the new contract is now deemed to be $2,300 ($2,200 as original calculations + $100). This is allocated equally between NS4 and ES9, based on the fact that their standalone selling prices are equal, and the conditions to allocate variable consideration to only one performance obligation are not met (see section 2.4.3).

Therefore $1,150 revenue is recognised when control of NS4 passes to the customer and another $1,150 revenue is recognised when control of ES9 passes.
SECTION SUMMARY

SFRS(I) 15 requires that certain contract modifications are accounted for as separate contracts. Accounting for a change in transaction price is dependent upon whether a modification has occurred previously and how that modification was accounted for.

4 Contract costs

SECTION INTRODUCTION

SFRS(I) 15 provides guidance on accounting for costs relating to contracts.

Costs may arise in relation to obtaining a contract and in relation to fulfilling a contract. SFRS(I) 15 provides guidance on how to account for each of these, and specifically when an asset can be recognised in respect of costs incurred.

4.1 Costs of obtaining a contract

The incremental costs of obtaining a contract (such as sales commission) are recognised as an asset if the entity expects to recover those costs. Any other costs, including those that would have been incurred regardless of whether the contract was obtained are recognised as an expense as incurred.

4.2 Costs of fulfilling a contract

Costs incurred in fulfilling a contract, unless within the scope of another standard (such as SFRS(I) 1-2 Inventories, SFRS(I) 1-16 Property, Plant and Equipment or SFRS(I) 1-38 Intangible Assets) are recognised as an asset if they meet the following criteria:

- The costs relate directly to an identifiable contract
- The costs generate or enhance resources of the entity that will be used in satisfying (or continuing to satisfy) performance obligations in the future
- The costs are expected to be recovered

The following costs are recognised as expenses when incurred:

(a) General and administrative costs;
(b) Costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract;
(c) Costs that relate to satisfied, or partially satisfied, performance obligations in the contract; and
(d) Costs for which an entity cannot distinguish whether costs relate to unsatisfied or satisfied performance obligations.
4.3 Amortising and impairing cost assets

4.3.1 Amortisation

Costs (of obtaining or fulfilling a contract) that are recognised as assets are amortised on a systematic basis consistent with the transfer to the customer of the goods or services to which the asset relates.

If the timing of transfer of goods or services to a customer changes, the resulting change to amortisation is accounted for prospectively as a change in accounting estimate.

4.3.2 Impairment

An impairment loss exists in relation to capitalised costs if the carrying amount of those costs exceeds the following amount:

- The remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates (determined in the same way as transaction price other than constraining estimates of variable consideration, and adjusted for customer credit risk)
- Costs that relate directly to providing those goods or services that have not been recognised as expenses
- Impairment losses related to assets associated with a contract but recognised in accordance with other standards (eg SFRS(I) 1-2) should be recognised first.

Impairment losses in relation to capitalised contract costs are recognised in profit or loss.

Reversals of impairment losses may be recognised if the conditions that led to the impairment no longer exist, however the carrying amount of the contract cost asset should not exceed the amount of the carrying amount if no impairment loss had been recognised.

Example

Pacific Services Limited (PSL) contracts to provide a customer’s in house technical training services for four years, with one-year contract extensions available on a rolling basis. The average customer term is six years. PSL pays its customer relationship manager a $15,000 bonus on the signing of the contract. In order to deliver the agreed service, PSL invests in technology that is compatible with the customer’s internal systems:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hardware</td>
<td>140,000</td>
</tr>
<tr>
<td>Software</td>
<td>45,000</td>
</tr>
<tr>
<td>Set up and testing of compatible technology</td>
<td>25,000</td>
</tr>
</tbody>
</table>

How should PSL account for the costs associated with the contract?

Solution

The bonus paid to the customer relationship manager is a cost of obtaining the contract. This is recognised as an asset because PSL expects to recover the costs through future fees charged to the customer for services to be provided.

The hardware is property, plant and equipment and is accounted for in accordance with SFRS(I) 1-16 (ie recognised at cost of $140,000 and depreciated over its useful life).

The software is an intangible asset and is accounted for in accordance with SFRS(I) 1-38 (ie recognised at cost of $45,000 and amortised over its useful life).
The set up and testing costs do not fall within the scope of another standard. These costs:

- Relate directly to the contract (as they concern technology that is specific to this customer);
- Enhance the resources of PSL that will be used to deliver training under the contract; and
- Are expected to be recovered (through fees charged to the customer).

Therefore they are capitalised in line with SFRS(I) 15.

Total costs capitalised in line with SFRS(I) 15 are $40,000 (25,000 + 15,000). These are amortised over the period over which goods/services are expected to be transferred to the customer ie 6 years. Annual amortisation is therefore $6,667.

**SECTION SUMMARY**

The costs of obtaining a contract are recognised as an asset if the entity expected to recover those costs.

The costs of fulfilling a contract are recognised as an asset if they relate directly to an identifiable contract, they relate to the satisfaction of a future performance obligation and the costs are expected to be recovered.

**5 Presentation and disclosure**

**SECTION INTRODUCTION**

Contracts with a customer may be recognised in the statement of financial position as a contract liability, a contract asset or a receivable.

**5.1 Presentation**

Depending on the relationship between the entity's performance and its customer's payment, a contract asset, contract liability or contract receivable may be recognised in the statement of financial position:

<table>
<thead>
<tr>
<th>Contract liability</th>
<th>Arises where a customer has paid an amount of consideration (or consideration is due from the customer) prior to the selling entity transferring control of the related goods/service to the customer (ie prior to meeting the performance obligation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract asset</td>
<td>Arises where the entity has met its performance condition but not yet received the related consideration and receipt of that consideration is conditional upon something other than the passage of time eg future performance. A contract asset is assessed for impairment in line with SFRS(I) 9 (see Chapter 16).</td>
</tr>
<tr>
<td>Receivable</td>
<td>Arises where the entity has met its performance condition but not yet received the related consideration and receipt of that consideration is unconditional other than the passage of time.</td>
</tr>
</tbody>
</table>
A single contract is presented as either a net contract asset or a net contract liability; a receivable is presented separately.

Contract assets and liabilities in respect of different customers are not offset.

The standard permits terms other than ‘contract asset’ or ‘contract liability’ to be used.

Example

An entity enters a non-cancellable contract with a customer on 21 September 20X7. The contract requires the selling entity to transfer goods on 30 November 20X7 and requires the customer to pay for these in advance on 30 September 20X7. The customer pays on 15 October 20X7. The transaction price is the contract price of $35,000.

What journals are required by the selling entity in order to recognise the transaction?

Solution

21 September 20X7
No entries are required to recognise an amount receivable at this date as consideration is not yet due or earned.

30 September 20X7
The selling entity has an unconditional right to consideration at this date and recognises a receivable. It also recognises a contract liability by ($):

DEBIT Receivable 35,000
CREDIT Contract liability 35,000

15 October 20X7
The customer pays the amount due, which is recognised by ($):

DEBIT Bank 35,000
CREDIT Receivable 35,000

30 November 20X7
Goods are transferred to the customer and revenue is recognised by ($):

DEBIT Contract liability 35,000
CREDIT Revenue 35,000

5.1.1 Disclosure requirements

SFRS(I) 15 includes a cohesive set of disclosure requirements that will provide users of the financial statements with comprehensive information about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

SFRS(I) 15 requires that disclosure is made of:

(a) Revenue recognised from contracts with customers, including revenue by category
(b) Contract balances, including the opening and closing balances of receivables, contract assets and contract liabilities
(c) Performance obligations, including when the entity typically satisfies its performance obligations
(d) The transaction price allocated to remaining performance obligations
(e) Significant judgments, and changes in judgments, made in applying the requirements of the standard
(f) Assets recognised from the costs to obtain or fulfil a contract with a customer.
6 Specific applications

SECTION INTRODUCTION

The Application Guidance that accompanies SFRS(I) 15 Revenue from Contracts with Customers includes a number of practical applications of the standard.

6.1 Sales with a right of return

Some contracts may give the customer the right to return goods they have purchased and obtain a full or partial refund of consideration, a credit to be applied against amounts owed or another product in exchange.

For example, retailers often have a policy of giving refunds on returned goods, whether or not the goods are defective.

When goods are transferred to a customer with a right of return:

(a) Revenue is recognised to the extent that the seller expects to be entitled to it (therefore no revenue is recognised for goods expected to be returned);

(b) A refund liability is recognised for goods expected to be returned; and

(c) An asset is recognised which represents the selling entity's right to recover returned goods from a customer.

The refund liability should be updated at the end of each reporting period for changes in expectations about the amount of refunds.

Question 17.6

Fashionfocus.com sells clothing on the internet. Customers are entitled to return items within 28 days of purchase for a full refund if they do not fit or are otherwise not suitable. In the final week of December 20X6, Fashionfocus.com sold 150 ‘Gina’ cocktail dresses for $500 each. The dresses cost $200 each. Fashionfocus.com has an expected level of returns of 20% on average; none of the dresses sold in the final week of December has been returned by the end of the month. Fashionfocus.com holds a sale every January and will reduce the selling price of the Gina dress to $400.

What journal entry is required to recognise the sale transaction in Fashionfocus.com's financial statements for the year ended 31 December 20X6?
6.2 Warranties

Sales contracts commonly include warranties; SFRS(I) 15 identifies three types of warranty and prescribes the accounting treatment for each:

<table>
<thead>
<tr>
<th>Type of Warranty</th>
<th>Accounting Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard warranty at no cost to the customer that the product will function as intended</td>
<td>Apply SFRS(I) 1-37</td>
</tr>
<tr>
<td>Additional warranty available to a customer at a cost</td>
<td>Apply SFRS(I) 15; additional warranty is a performance obligation in sale contract</td>
</tr>
<tr>
<td>Additional warranty at no cost to the customer that provides additional service (beyond assurance that the product will function as intended)</td>
<td></td>
</tr>
</tbody>
</table>

When considering whether a warranty at no cost provides a customer with an additional service (and therefore is an additional warranty rather than a standard warranty), the following factors should be considered:

(a) Whether the warranty is required by law (if so, it is likely to be a standard warranty)
(b) The length of the warranty cover (the longer the cover, the more likely that it is an additional warranty)
(c) The nature of the tasks that the selling entity promises to perform (and whether these would be required to provide assurance that a product functions as intended).

Question 17.7 Warranties

Prosperity Boats Deluxe (PBD) is a retailer of boats and yachts, with a year-end of 30 June. It sells one model – the $3 million Mini-Lux yacht with a 12-month warranty that the yacht will function as intended. As sales of the yacht are slow, PBD is also offering customers a three-year service plan, normally sold for $120,000, included free in the price of the yacht. This plan provides for a six monthly servicing of the yacht.

On 31 May 20X7, a customer agrees to buy a Mini-Lux yacht, paying the deposit of $300,000. Delivery is arranged for 1 August 20X7, on which date the balance of $2.7 million is paid.

As the sale has now been made, the director of Prosperity Boats Deluxe wishes to recognise the full sale price of the yacht, $3 million, in the accounts for the year ended 30 June 20X7.

Required

Advise the director of the correct accounting treatment for this transaction as at 31.5.X7 and 1.8.X7. Assume a 10% discount rate. Show the journal entries for this treatment.

6.3 Principal and agent transactions

An entity may be a principal or an agent in a sales transaction:

(a) A principal controls goods or services before they are transferred to the customer (i.e., the entity is selling its own goods)
(b) An agent does not control goods or services prior to transfer to the customer, instead it arranges for them to be provided by another party.
In a contract with a number of performance obligations, the selling entity may be principal for some and agent for others. Therefore it should assess each individually to assess whether it controls the promised good or service prior to transfer.

**6.3.1 Indicators of principal**

Indicators that an entity is a principal may include:

(a) The entity is primarily responsible for fulfilling the promise to provide the specified good or service

(b) The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer (in the case of sale with a right of return)

(c) The entity has discretion to establish prices of specified goods or services (although an agent may have some flexibility with pricing).

When an entity obtains goods and services from another entity before transferring them to a final customer, the entity is a principal in the following situations:

1. It has obtained control of an asset from another party which it then transfers to a customer, or
2. It has obtained control of a right to a service to be performed by another party and the entity can direct that service on behalf of a customer.
3. It has obtained goods or services from another party that it combines with other goods or services to provide a specified good or service to the customer.

**6.3.2 Measurement of revenue**

Revenue is measured as follows:

**Principal**

Gross amount of consideration expected to be received

**Agent**

Fee or commission for selling items on behalf of the principal

**Question 17.8**

**Principal and agent**

Online Traders Ltd (OTL) operates a website through which independent retailers that don't have an online presence can sell their goods to customers. The retailers set the prices charged for their goods, however OTL decides how goods are presented on its website and customers make payment to OTL. OTL advises retailers of sales made, including details of products and delivery addresses, at the end of each day, and advances 93% of payments from customer to the relevant independent retailer. Individual retailers are responsible for despatching goods to customers.

Explain whether OTL is an agent or principal in the sales transactions.

**6.4 Customer options for additional goods or services**

A contract may include an option for a customer to acquire additional goods or services for free or at a discount. Such an option may be in the form of customer points or award credits in a customer loyalty scheme eg Singapore Airlines' KrisFlyer programme. Alternatively it may take the form of a discount voucher for a future purchase or a contract renewal option.
Points or award credits are awarded to a customer when a sale is made to them. These points equate to a promise by the selling entity to deliver goods or services in the future when the points are redeemed and therefore provide a material right to the customer that they wouldn't otherwise receive. The provision of the points therefore form a separate performance obligation in the original sales transaction:

Eg the sale of a Singapore airlines flight from Singapore to Sydney is made up of two performance obligations:

\[
\text{Sale} \quad = \quad \text{Promise to provide flight from Singapore to Sydney} \quad + \quad \text{Promise to provide service in future when KrisFlyer points redeemed}
\]

6.4.1 Allocation of transaction price to performance obligation

The amount of the transaction price allocated to a promise to deliver future goods or services when reward points are redeemed is, in line with SFRS(I) 15, based on the standalone selling price of the goods or services that the points give a customer access to.

As the goods or services will be provided in the future, standalone selling prices may have to be estimated and should take into account the discount that the customer would obtain on the exercise of the option, adjusted for:

- Any discount that the customer would receive without exercising the option; and
- The likelihood that the option would be exercised.

6.4.2 Accounting entries

The proportion of transaction price received from the customer and allocated to the promise to deliver goods or services in the future is recognised as a contract liability and transferred to revenue at the earlier of:

- The date on which the future goods and services are provided; or
- The date on which the reward points that give access to future goods or services expire.

Example

Pizza Pie Company (PPC) started business on 1 January 20X6 selling takeaway pizzas at a fixed price of $20, and awarding customers with a PPC point worth $1 with every pizza sold. When a customer has collected 20 PPC points, they can order a pizza free of charge. During 20X6, PPC sold 100,000 pizzas and provided 1,250 pizzas free of charge on redemption of PPC points. The company estimates that 3,900 free pizzas will be claimed in total in relation to sales in 20X6.

Explain how revenue is recognised in the year ended 31 December 20X6.

Solution

The PPC points scheme provides customers with a material right that they would not have had they not bought pizzas from PPC. Therefore the promise to provide a free pizza on redemption of 20 PPC points is a performance obligation. The total revenue of $2 million (100,000 \times $20) is allocated between the provision of pizzas and the provision of PPC points.

The sale of 100,000 pizzas results in a maximum provision of 5,000 free pizzas (100,000/20), however PPC expect only 3,900 to be claimed. The revenue allocated to the points scheme is therefore based on a standalone selling price of free pizzas of $78,000 (3,900 pizzas at $20 each):

| Pizza sales $2 million \times (2m/2.078m) | $1,924,928 |
| PPC points $2 million \times (0.078/2.078) | $75,072 |
At the reporting date, 1,250 pizzas have been claimed and therefore of the $75,072 transaction price allocated to the provision of PPC points, $24,062 \ (75,072 \times \frac{1,250}{3,900}) \) should be recognised as revenue in the period.

Total revenue in the period is therefore $1,948,990 \ (1,924,928 + 24,062) \).

A contract liability of $51,010 \ (75,072 - 24,062) \) is recognised for the unredeemed PPC points.

6.5 Licensing

An entity may sell a licence, being the ability for a customer to access intellectual property eg trademarks, music, films, patents, franchises and software.

A contract that includes a promise to grant a licence may also include a promise to transfer other goods or services to the customer. The promise to transfer the licence may, or may not, be distinct from other promises, and therefore may be a separate performance obligation or may form part of a performance obligation together with other promises. For example, a software licence that requires ongoing upgrades, which are necessary for the software to function. In this situation the promise to provide software and the promise to grant a licence are combined to be a single performance obligation.

6.5.1 Royalties

If consideration in a contract to licence intellectual property is a royalty measured by reference to sales or usage, the selling entity should recognise revenue at the later of:

- The subsequent sale or usage; and
- The satisfaction of the performance obligation to which some or all of the sales or usage based royalty has been allocated.

6.6 Sale and repurchase agreements

A sale and repurchase agreement is a transaction where entity A sells an asset to entity B, but the terms of the sale provide for the asset to be repurchased by entity A at a later date under certain conditions. The repurchased asset may be the original asset that was sold, an asset that is substantially the same as that asset or another asset of which the original asset is a component.
This is a common arrangement amongst whisky distillers, who sell their stocks to banks or other lending bodies while they mature. When the whisky has matured, it is re-purchased by the distillery for an amount equal to the original sum plus an interest component. The whisky is never physically transferred to bank premises, but remains on site at the distillery.

Sale and repurchase arrangements generally come in three forms:

1. A forward (whereby the selling entity is obliged to repurchase the asset)
2. A call option (whereby the selling entity has a right to repurchase the asset), or
3. A put option (whereby the customer (the buying entity) has a right to enforce the selling entity to repurchase the asset).

The accounting treatment of these differs.

### 6.6.1 Forward and call options

In these situations the customer has limited ability to use the transferred asset and obtain its benefits and therefore control of the asset does not pass from the selling entity.

The accounting treatment applied to these situations depends on the relationship between the selling and repurchase prices:

<table>
<thead>
<tr>
<th>Repurchase price ≥ Selling price</th>
<th>Repurchase price &lt; Selling price</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="Diagram.png" alt="Diagram" /> Transaction part of sale and leaseback transaction</td>
<td><img src="Diagram.png" alt="Diagram" /> Transaction not part of sale and leaseback transaction</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Account for as a financing arrangement (SFRS(I) 9)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>Continue to recognise asset</td>
</tr>
<tr>
<td>(b)</td>
<td>Recognise financial liability for consideration received</td>
</tr>
<tr>
<td>(c)</td>
<td>Recognise difference between repurchase price and selling price as interest</td>
</tr>
</tbody>
</table>

If the option lapse unexercised, the financial liability is transferred to revenue

### 6.6.2 Put options

Again the accounting treatment depends on the relationship between the repurchase price and selling price, and also whether the customer would have a significant economic incentive to force repurchase at the start of the arrangement.
When considering whether there is a significant economic incentive to force repurchase at the start of the arrangement, a number of factors should be considered including the relationship of the repurchase price to market value at the repurchase date.

### Example

Straits Construction Limited (SCL) sold its head office to the Singapore Banking Corporation (SBC) on 1 March 20X2 for $30 million. SCL is obliged to repurchase the property on 1 March 20X7 for $36.5 million.

Five year discount factors are:

- 2%: 0.906
- 3%: 0.863
- 4%: 0.822
- 5%: 0.784

Explain how the sale and repurchase is accounted for in the year ended 28 February 20X3.

### Solution

The sale contract includes a forward and the repurchase price is more than the selling price, therefore the transaction is a financing arrangement within the scope of SFRS(I) 9.

The $30 million received from SBC is recognised by ($ million):  

\[\text{DEBIT} \quad \text{Bank} \quad 30\]  
\[\text{CREDIT} \quad \text{Financial liability at amortised cost} \quad 30\]

In order for the carrying amount of the liability of $30 million to be wound up to $36.5 million by the repayment date, an effective interest of 4% must be applied ($36.5m \times 0.822 = 30m$).

Therefore in the year ended 28 February 20X3, a finance cost of $1.2 million ($30m \times 4\%) is recognised by ($ million):

\[\text{DEBIT} \quad \text{Finance cost} \quad 1.2\]  
\[\text{CREDIT} \quad \text{Financial liability at amortised cost} \quad 1.2\]
6.7 Consignment arrangements

Consignment arrangements are transactions whereby entity A transfers goods (consignment inventory) to entity B and entity B undertakes to sell the goods to a third party on behalf of entity A. Entity B is often referred to as a dealer or distributor.

This is a very common arrangement in the motor industry where a manufacturer delivers cars to a dealer who sells them on to the final consumer. The manufacturer retains legal title until the cars are sold on to a third party and the dealer can normally return unsold cars to the manufacturer.

In this situation, the issue is whether control has passed from the seller (the manufacturer) to the buyer (the dealer) on delivery of the goods and therefore whether revenue should be recognised by the seller (manufacturer) at this time.

If control has not passed on delivery, the seller (manufacturer) does not recognise revenue until goods are sold onward (by the dealer) to a third party.

Indicators that revenue should not be recognised on transfer to a dealer include:

(a) The product or goods are controlled by the selling entity until a specific event occurs or a specified period expires;

(b) The selling entity can require the return of the product or transfer it to another party (e.g., another dealer); and

(c) The dealer does not have an unconditional obligation to pay for the product.

6.8 Bill and hold sales

A bill and hold sale is a sale where the buyer takes title of goods purchased and accepts billing, but requests that delivery be delayed (e.g., due to lack of available space or in order to facilitate a 'just-in-time' approach to production).

SFRS(I) 15 requires that revenue is recognised when the customer takes control. This may or may not be when the customer takes control of the physical asset.

In addition to applying the usual SFRS(I) 15 conditions indicating that control of an item has passed to the customer, the following conditions must be met:

(a) The reason for the arrangement is substantive (e.g., it is at the customer's request);

(b) The goods can be identified separately as belonging to the customer;

(c) The product is ready for physical delivery to the customer; and

(d) The selling entity is not able to use the product or direct it to another customer.

6.9 Unexercised rights

A selling entity may receive a non-refundable deposit from its customer in advance of delivery of goods or services that are promised in a contract. In that case, the selling entity should recognise a contract liability. This accounting treatment also applies when retailers sell gift cards.

The contract liability recognised by the selling entity represents the customer's right to a good or service in the future. Assuming that the customer exercises their rights (and so proceeds with the sale for which a deposit was paid, or spends a gift card) the contract liability is derecognised and transferred to be revenue when the related performance obligation is satisfied.

A customer may, however, not exercise their right to a good or service (e.g., they may cancel the contract before delivery or not use a gift card) or the full amount of a gift card from a retailer. The amount attributable to customers' unexercised rights is often called 'breakage', and the issue is if and when a selling entity should recognise it as revenue.

Breakage is a form of variable consideration and therefore it is only recognised as revenue when it is highly probable that a significant revenue reversal will not occur.
(a) If a selling entity expects to be entitled to a breakage amount in a contract liability, it should recognize breakage as revenue in proportion to the pattern of rights exercised by the customer.

(b) If a selling entity does not expect to be entitled to a breakage amount in a contract liability, it should recognize breakage as revenue when the likelihood of the customer exercising their rights becomes remote.

Example

Peninsula Fashion Ltd (PNL) sells a $100 gift card to a customer on 12 January 20X7; the card has no expiration date. PFL has sold gift cards for a number of years and based on past experience, estimates that 5% of gift card balances will not be redeemed by the customer. It also considers that it is highly probable that a significant revenue reversal will not occur for this 5% estimated breakage amount.

On 19 February 20X7, the customer returns to the PFL store and purchases $57 goods using the gift card.

How should PFL account for the sale of the gift card and the subsequent redemption?

Solution

On 12 January 20X7 the sale of the gift card is recognised by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>Contract liability</td>
</tr>
<tr>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

The estimated breakage within this amount is $5 ($100 × 5%)

On 19 February, the customer spends $57 using the gift card. This is derecognised as a contract liability and recognised as revenue.

PFL expects the customer to spend $95 of the gift card in total (the full amount less breakage). Therefore the $57 spend represents 60% of expected spend ($57/$95 × 100%). As expected breakage is recognised in proportion to actual expected expenditure, 60% of the breakage i.e $3 (60% × $5) is also recognised as revenue.

The redemption transaction is recognised by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract liability (57 + 3)</td>
<td>Revenue</td>
</tr>
<tr>
<td>60</td>
<td>60</td>
</tr>
</tbody>
</table>

6.10 Non-refundable upfront fees

A selling entity may charge a customer a non-refundable upfront fee, for example joining fees in relation to a sports or health club membership, activation fees in telecommunication contracts and initial fees in some supply contracts.

The selling entity should determine whether the fee relates to a separate performance obligation (a distinct transfer of goods or services) or to setup activities in advance of a future transfer of goods or services. In practice, upfront fees typically relate to setup activities in advance of a future transfer of goods or services.

Where the fee is determined to relate to setup activities, it is recognised as an advance payment for future goods or services (a contract liability) and is transferred to be revenue only when the goods or services are provided.
SECTION SUMMARY

The Application Guidance to SFRS(I) 15 provides a number of practical examples of the application of guidance in the standard. Scenarios include:

- Sales with a right of return
- Warranties
- Principal and agent transactions
- Options for additional goods or services
- Licensing
- Repurchase agreements
- Consignment arrangements
- Bill and hold sales
- Customers’ unexercised rights
- Non-refundable upfront fees
Chapter Roundup

**SFRS(I) 15 Revenue from Contracts with Customers**

- **Step 1:** Identify the contact with the customer
- **Step 2:** Identify separate performance obligations where promised goods/services are distinct.
- **Step 3:** Determine the transaction price
  - Significant financing components
  - Amounts payable to customer
  - Refund liabilities
  - Variable consideration
  - Non-cash consideration
- **Step 4:** Allocate the transaction price to the performance obligations based on standalone prices

- **Step 1:** Recognise revenue when performance obligations satisfied
  - At a single point in time
  - Over time

- **Statement of financial position:**
  - Contract asset
  - Contract liability
  - Receivable

**Specific applications:**
- Sale with right of return
- Warranties
- Principal and agent
- Options for additional goods/services
- Licensing
- Sale and repurchase
- Consignment arrangement
- Bill and hold sales
- Customers’ unexercised rights
- Non-refundable upfront fees

**Changes in transaction price during contract term**

**Contract modification**
Quick Quiz

1. What conditions must be met in order for goods or services to be distinct?
2. When is variable consideration included in the transaction price?
3. How is a discount allocated to the performance obligations in a contract?
4. What methods may be used to assess progress towards satisfaction of a performance obligation satisfied over time?
5. When is a modification accounted for as a separate contract?
6. If contract costs are capitalised, how are they subsequently measured?
7. How is an additional warranty accounted for?
8. What revenue does an agent recognise?
9. In a sale and repurchase transaction that the seller can enforce, what accounting standard is applied if the repurchase price is less than the selling price and the transaction is not part of a sale and leaseback transaction?
Answers to Quick Quiz

1. The good or service could benefit the customer alone or together with other resources that are readily available to the customer and the entity's promise to transfer goods or services to a customer is separately identifiable from other promises in the contract.

2. It is included only if it is highly probable that a significant amount will not be reversed.

3. Proportionately to all performance obligations in the contract on the basis of standalone selling prices unless there is evidence that it only relates to certain performance obligations in the contract.

4. Input or output methods. Input methods may be based on costs incurred, labour hours incurred, time elapsed as proportions of total expected amounts. Output methods may be based on units produced, work certified or contract milestones.

5. When the scope of the contract increases and the increase to contract price reflects additional goods or services promised.

6. Cost less amortisation (over the period that goods and services in the related contract are transferred to the customer) and impairment.

7. As a separate performance obligation to which transaction price is allocated.

8. The commission or fees that they expect to be entitled to.

9. SFRS(I) 16 Leases

Answers to Questions

17.1 Identify the contract with the customer

In each case there must be a contract and the SFRS(I) 15 criteria must be met:

(a) The parties to the contract have approved it and are committed to performing their obligations under it;

(b) Each party's rights regarding the goods and services to be transferred can be identified

(c) The payment terms regarding the goods and services to be transferred can be identified

(d) The contract has commercial substance

(e) It is probable that the seller will collect the consideration to which it is entitled (after considering the customer's ability and intention to pay and the existence of variable consideration).

WRL

In the case of WRL, there is a contract and it appears that WRL and the customer have approved it and are committed to it. Rights and payment terms regarding the goods and services transferred can be identified and the contract has commercial substance. The issue is whether it is probable that WRL will collect the consideration to which it is entitled. The contract price is $5,000, however WRL expects to collect only $3,000 due to economic recession and political instability in the region in which the customer is based. WRL is therefore effectively providing a price concession; $2,000 of the contract price is variable consideration that WRL does not expect to collect, and the transaction price is the $3,000 that it does expect to collect. Based on this transaction price, the final criterion is met ie it is probable that WRL will collect the consideration to which it is entitled, being $3,000. This is a contract within the scope of SFRS(I) 15.
SPC

The contract is implied, by virtue of the fact that the patient is admitted and treated (a customary business practice). However the patient (being the customer) is unable to approve or commit to the contract before the treatment is provided and equally at that time SPC cannot assess a probability of collecting the $8,000 treatment price. Therefore this is not a contract within the scope of SFRS(I) 15. SPC should continue to assess the contract based on updated facts and circumstances. When further facts are gathered about the patient's ability and intention to pay all or part of the treatment price the contract may be assessed as being within the scope of SFRS(I) 15. An estimation of the amount that the patient will pay may be based on discussions with the patient or it may be determined by allocating the patient to a 'customer class' and considering historical cash collections from this customer class.

GPL

Both parties have committed to a contract within which rights and payment terms regarding the retail unit are identified; the contract has commercial substance. Regarding probable collectability of consideration, the customer's ability to pay may be in doubt. The customer intends to repay the $2.8million that GPL has financed using income from operations, however the customer's inexperience in the electrical goods retail field and the existence of competition means that there is a high risk of non-payment. Furthermore there is no evidence that the customer can repay the loan through other income or assets and the customer's liability is limited as the loan is non-recourse in nature. Therefore this is not a contract within the scope of SFRS(I) 15. GPL should recognise the non-refundable deposit (and any future payments received) as a liability until:

- It concludes that the probable collectability criterion is met;
- The contract is terminated; or
- Substantially all of the consideration due from the customer has been received.

At this stage the liability is transferred to be recognised as revenue.

17.2 Identify the separate performance obligations

The customer can benefit from each of the goods or services on a standalone basis or together with readily available resources ie it could acquire each good or service from a separate provider. Therefore each of the 7 goods and services (project management, procurement of materials, engineering, site clearance, construction, piping and wiring, finishing) provided by CBS is capable of being distinct. In the context of this contract, however, the promise by CBS to deliver each good or service is not distinct from the promises to deliver the others. This is because CBS provides a significant service of integrating the goods or service with other goods or services promised in the contract; CBS integrates the inputs to produce the output (the office block) for which the customer has contracted.

Therefore this is a single performance obligation.

17.3 Significant financing component

The transaction price is $1,295,756 (1,500,000/1.053)

This is recognised as revenue on 31 December 20X3 by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Receivable</th>
<th>1,295,756</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Revenue</td>
<td>1,295,756</td>
</tr>
</tbody>
</table>

To recognise revenue in respect of sales made on 31 December 20X3

In the year ended 31 December 20X4, the discount is unwound by $64,788 (5% × 1,295,756).

This is recognised by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Receivable</th>
<th>64,788</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Interest income</td>
<td>64,788</td>
</tr>
</tbody>
</table>

To unwind one year's discount.

Therefore the receivable is reported at $1,360,544 in the statement of financial position at 31 December 20X4 and by 31.12.20X6, the receivable will be $1,500,000.
17.4 Variable consideration

The consideration is variable due to the existence of a performance bonus. The transaction price could be calculated at $245,000 based on expected values \((75\% \times 250,000) + (25\% \times 230,000)\), however as there are only two possible outcomes it is more appropriate to use the single most likely outcome approach. This would give a transaction price of $250,000.

17.5 Allocation of transaction price to performance obligations

There are three distinct performance obligations and the total contract price of $1,800 is allocated based on standalone selling prices. The total of standalone selling prices is $2,000 \((850 + 100 + 1,050)\)

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Allocation</th>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Handset</td>
<td>850/2,000 (\times) 1,800</td>
<td>= $765</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>100/2,000 (\times) 1,800</td>
<td>= $90</td>
<td></td>
</tr>
<tr>
<td>Data and calls package</td>
<td>1,050/2,000 (\times) 1,800</td>
<td>= $945</td>
<td></td>
</tr>
</tbody>
</table>

17.6 Sales with a right of return

Based on sales of 150 dresses, Fashionfocus.com would expect 30 returns \((20\% \times 150)\).

Therefore the sales in the final week of December are accounted for by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank (150 (\times) $500)</td>
<td>75,000</td>
</tr>
<tr>
<td>Cost of sales (120 (\times) $200)</td>
<td>24,000</td>
</tr>
<tr>
<td>Right to recover goods (30 (\times) $200)</td>
<td>6,000</td>
</tr>
<tr>
<td>Credit Revenue (120 (\times) $500)</td>
<td>60,000</td>
</tr>
<tr>
<td>Refund liability (30 (\times) $500)</td>
<td>15,000</td>
</tr>
<tr>
<td>Inventory (150 (\times) $200)</td>
<td>30,000</td>
</tr>
</tbody>
</table>

17.7 Warranties

The SFRS(I) 15 five-step approach should be used:

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Identify the contract with a customer</td>
<td>PBD has a contract with the customer to transfer a yacht with warranty and a three year service plan.</td>
</tr>
<tr>
<td>2</td>
<td>Identify the separate performance obligations in the contract</td>
<td>The promise to transfer the yacht is a distinct performance obligation, as is the promise to provide servicing for three years (as these promises are separately identifiable). The promise to provide a warranty does not provide the customer with any assurance beyond the fact that the yacht will operate as intended for one year. Therefore this is not a performance obligation.</td>
</tr>
<tr>
<td>3</td>
<td>Determine the transaction price</td>
<td>The transaction price is fixed at $3 million.</td>
</tr>
</tbody>
</table>
| 4    | Allocate the transaction price to the separate performance obligations in the contract. | The $3 million is allocated based on standalone prices:
Yacht \((3m/3.12m \times 3m) = $2,884,615\)
Service plan \((0.12/3.12 \times 3m) = $115,385\) |
| 5    | Recognise revenue when (or as) the entity satisfies a performance obligation | $2,884,615 is recognised as revenue when control of the yacht is transferred to the customer on 1 August 20X7
$115,385 is recognised over the three year period from 1 August 20X7 to 31 July 20Y0. As a service is provided every six months, it would be appropriate to recognise revenue of $19,231 \((115,385/6)\) when each service is delivered. |
Required journal entries (in $):

31 May 20X7

DEBIT Bank 300,000
CREDIT Contract liability 300,000

1 August 20X7

DEBIT Contract liability 184,615
DEBIT Bank 2,700,000
CREDIT Revenue 2,884,615

At this date a warranty provision should also be made in accordance with SFRS(I) 1-37 for the estimated costs of meeting obligations under the warranty agreement.

At the date of each service, revenue is recognised by ($):

DEBIT Contract liability 19,231
CREDIT Revenue 19,231

17.8 Principal and agent

The individual retailers rather than OTL are responsible for fulfilling delivery of ordered items.

Individual retailers also have inventory risk before goods have been transferred to a customer or after transfer (in the case of sale with a right of return).

Individual retailers determine the prices of specified goods or services.

All of these factors indicate that OTL is an agent and should recognise revenue only to the extent of commission paid to it by the independent retailers ie 7% of sales made.
PART F
Disclosure and Reporting
Earnings per share (EPS) is an important performance indicator and is used internationally as a comparative performance figure.

SFRS(I) 1-33 provides guidance on how EPS should be calculated and presented in the financial statements. The standard is applicable to listed companies and entities whose ordinary shares are issued or likely to be traded in public markets.
18: Earnings per share | PART F DISCLOSURE AND REPORTING

**Syllabus Handbook**

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Earnings per Share</strong></td>
<td></td>
</tr>
<tr>
<td>Apply and explain the rules for reporting basic and diluted earnings per share, including where multiple potential ordinary shares are in existence.</td>
<td>3</td>
</tr>
<tr>
<td>Apply and explain the rules for disclosure of alternative measures of earnings per share.</td>
<td>3</td>
</tr>
<tr>
<td><strong>Emerging Trends</strong></td>
<td></td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments.</td>
<td>1</td>
</tr>
</tbody>
</table>

**ESSENTIAL READING**

SFRS(I) 1-33 *Earnings per Share*, SFRS(I) 1-33 Illustrative Examples

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### 1 Introduction and definitions

**SECTION INTRODUCTION**

SFRS(I) 1-33 *Earnings Per Share* sets out how to calculate both basic earnings per share (EPS) and diluted earnings per share.

The objective of SFRS(I) 1-33 is to improve the *comparison* of the earnings performance as a function of the number of ordinary shares issued by different entities in the same period and by the same entity in different accounting periods.

#### 1.1 Scope

SFRS(I) 1-33 has the following *scope restrictions*.

(a) Only companies with (potential) ordinary shares which are *publicly traded* (including companies in the process of being listed) need to present EPS.

(b) EPS need only be presented on the basis of *consolidated results* where the parent's results are shown as well.

(c) Where companies *choose* to present EPS, even when they have no (potential) ordinary shares which are publicly traded, they must do so according to SFRS(I) 1-33.
1.2 Definitions

The following definitions are given in SFRS(I) 1-33.

**KEY TERMS**

**ORDINARY SHARE** An equity instrument that is subordinate to all other classes of equity instruments.

**POTENTIAL ORDINARY SHARE** A financial instrument or other contract that may entitle its holder to ordinary shares.

**OPTIONS, WARRANTS AND THEIR EQUIVALENTS** Financial instruments that give the holder the right to purchase ordinary shares.

**CONTINGENTLY ISSUABLE ORDINARY SHARES** are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.

**CONTINGENT SHARE AGREEMENT** An agreement to issue shares that is dependent on the satisfaction of specified conditions.

**DILUTION** is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

**ANTI-DILUTION** is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

(SFRS(I) 1-33)

1.2.1 Ordinary shares

There may be more than one class of ordinary shares, each with different characteristics. For example the individual rights relating to different share classes may differ in one or more of the following ways:

(a) The voting rights attached to them
(b) The right to receive a dividend and whether that dividend is fixed or variable
(c) The right to a payout on the winding up of the company.

All shares within the same class will, however, have the same rights. Classes of shares that have fewer rights than other classes may be referred to as ‘subordinate’; for example, subordinate voting shares carry a right to vote, however another class of shares carries a greater voting right on a per share basis.

Ordinary shares participate in the net profit for the period **only after other types of shares**, eg preference shares, have participated.

1.2.2 Potential ordinary shares

SFRS(I) 1-33 identifies the following examples of financial instruments and other contracts generating potential ordinary shares.

(a) **Debts** (financial liabilities) or **equity instruments**, including preference shares, that are convertible into ordinary shares

(b) **Share warrants and options**

(c) Shares that would be issued upon the satisfaction of **certain conditions** resulting from contractual arrangements, such as the purchase of a business or other assets
2 Basic earnings per share

SECTION INTRODUCTION

Basic EPS is calculated based on net profit and the number of ordinary shares in issue.

Complications arise when new shares are issued for cash or there is a bonus or rights issue.

Basic EPS should be calculated for profit or loss attributable to ordinary equity holders of the parent entity and profit or loss from continuing operations attributable to those equity holders (if this is presented).

Basic EPS is calculated by dividing the net profit or loss after tax for the period attributable to ordinary equity holders by the weighted average number of ordinary shares outstanding during the period.

\[
\text{Net profit/(loss) after tax attributable to ordinary shareholders} \quad \frac{\text{Net profit/(loss) after tax attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding during the period}}
\]

2.1 Profit attributable to ordinary shareholders

Earnings is the profit after tax attributable to the owners of the parent company (ie excluding the non-controlling interest), adjusted for after-tax amounts of preference dividends, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as equity.

\[
\begin{align*}
\text{Profit after tax} & \quad X \\
\text{Less:} & \quad \text{(X)} \\
\text{Preference dividends not recognised in profit or loss} & \quad (X) \\
\text{Differences on settlement of preference shares not recognised in profit or loss} & \quad (X) \\
\text{Profit attributable to ordinary shareholders} & \quad X
\end{align*}
\]

Preference dividends deducted from net profit consist of the following:

(a) Preference dividends on non-cumulative preference shares declared in respect of the period.

(b) Preference dividends for cumulative preference shares required for the period, whether or not they have been declared (excluding those paid/declared during the period in respect of previous periods).

If an entity buys back its own preference shares for more than their carrying amount the excess is treated as a return to the preference shareholders and deducted in calculating profit or loss attributable to ordinary equity holders.

Example

A company has the following shares in issue at 31 August 20X3:

- 90 million ordinary shares of $90 million
- 10 million 8% irredeemable cumulative preference shares of $10 million
- 15 million redeemable preference shares of $7.5 million
The following is relevant to the year ended 31 August 20X3:

(a) Profit after tax was $45 million

(b) On 1 March 20X3 6 million 8% irredeemable cumulative preference shares were cancelled and shareholders were paid $1.20 per share.

What are profits attributable to ordinary shareholders for the year ended 31 August 20X3?

**Solution**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit after tax</td>
<td>$45,000,000</td>
</tr>
<tr>
<td>Irredeemable preference share dividend:</td>
<td></td>
</tr>
<tr>
<td>1 September 20X2 – 28 February 20X3 6/12 × 8% × 16m</td>
<td>(640,000)</td>
</tr>
<tr>
<td>1 March 20X3 – 31 August 20X3 6/12 × 8% × 10m</td>
<td>(400,000)</td>
</tr>
<tr>
<td>Cancellation of shares (1.20 – 1.00) × 6m</td>
<td>(1,200,000)</td>
</tr>
<tr>
<td>Profits attributable to ordinary shareholders</td>
<td>$42,760,000</td>
</tr>
</tbody>
</table>

**2.2 Weighted average number of shares**

The number of ordinary shares used should be the weighted average number of ordinary shares outstanding during the period. This figure (for all periods presented) should be adjusted for events, other than the conversion of potential ordinary shares, that have changed the number of shares outstanding without a corresponding change in resources.

The **time-weighting factor** is the number of days the shares were outstanding compared with the total number of days in the period. A reasonable approximation is usually adequate as shown below:

<table>
<thead>
<tr>
<th>Date</th>
<th>Number of Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 January 20X1</td>
<td>1,200,000</td>
</tr>
<tr>
<td>31 May 20X1</td>
<td>600,000</td>
</tr>
<tr>
<td>31 December 20X1</td>
<td>1,800,000</td>
</tr>
</tbody>
</table>

\[
\text{Weighted average number of shares} = \frac{1.2m \times 5/12 \text{months}}{1,550,000} = 500,000 \quad \text{and} \quad \frac{1,800,000 \times 7/12 \text{months}}{1,550,000} = 1,050,000
\]

Shares are usually included in the weighted average number of shares from the **date consideration is receivable** which is usually the date of issue. In other cases consider the specific terms attached to their issue (consider the substance of any contract). The treatment for the issue of ordinary shares in different circumstances is as follows.

<table>
<thead>
<tr>
<th>Consideration</th>
<th>Start date for inclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>In exchange for cash</td>
<td>When cash is receivable</td>
</tr>
<tr>
<td>On the voluntary reinvestment of dividends on ordinary or preferred shares</td>
<td>When dividend is reinvested</td>
</tr>
<tr>
<td>As a result of the conversion of a debt instrument to ordinary shares</td>
<td>Date interest ceases accruing</td>
</tr>
<tr>
<td>Consideration</td>
<td>Start date for inclusion</td>
</tr>
<tr>
<td>------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------</td>
</tr>
<tr>
<td>In place of interest or principal on other financial instruments</td>
<td>Date interest ceases accruing</td>
</tr>
<tr>
<td>In exchange for the settlement of a liability of the entity</td>
<td>The settlement date</td>
</tr>
<tr>
<td>As consideration for the acquisition of an asset other than cash</td>
<td>The date on which the acquisition is recognised</td>
</tr>
<tr>
<td>For the rendering of services to the entity</td>
<td>As services are rendered</td>
</tr>
</tbody>
</table>

Ordinary shares issued as **purchase consideration** in an acquisition should be included as of the date of acquisition because the acquired entity's results will also be included from that date.

Where a **uniting of interests** takes place the number of ordinary shares used for the calculation is the aggregate of the weighted average number of shares of the combined entities, adjusted to equivalent shares of the entity whose shares are outstanding after the combination.

Ordinary shares that will be issued on the **conversion** of a mandatorily convertible instrument are included in the calculation from the **date the contract is entered into**.

If ordinary shares are **partly paid**, they are treated as a fraction of an ordinary share to the extent they are entitled to dividends relative to fully paid ordinary shares.

**Treasury shares**, which are presented in the financial statements as a deduction from equity, are not considered outstanding for EPS purposes.

**Contingently issuable shares** are included in the computation when all necessary conditions for issue have been satisfied. Outstanding shares that are **contingently returnable** (ie subject to recall) are excluded from the calculation of basic EPS until the date the shares are no longer subject to recall.

### 2.3 Changes in capital

Where there is a share issue during the year for which EPS is being calculated, the denominator for the calculation of EPS must be adjusted to take into account the amount of the year for which additional shares have been in issue, and the consideration (if any) received on issue of those shares, which has contributed towards generating additional profits in the year. The principle here is we must compare like with like in the calculation of EPS: this is best seen through a series of practical examples.

#### 2.3.1 Share issue for cash

Where new shares are priced at market price and issued for cash, there is a corresponding increase in resources which are used to generate profits.

**Example**

Company A has a profit after tax of $20 million. The company had 12 million ordinary shares in issue at 1 January 20X3 and issued a further 3 million on 1 June 20X3 at the full market price for cash.

What is the basic earnings per share for the year ended 31 December 20X3?

**Solution**

<table>
<thead>
<tr>
<th>Earnings</th>
<th>Weighted average number of shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20 million</td>
<td>12m × 5/12 months</td>
</tr>
<tr>
<td></td>
<td>(12 + 3) × 7/12 months</td>
</tr>
<tr>
<td></td>
<td>5 million</td>
</tr>
<tr>
<td></td>
<td>8.75 million</td>
</tr>
<tr>
<td></td>
<td>13.75 million</td>
</tr>
</tbody>
</table>
Therefore basic EPS

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20,000,000</td>
<td>145.45 cents</td>
</tr>
<tr>
<td></td>
<td>13,750,000</td>
<td></td>
</tr>
</tbody>
</table>

If you prefer, you can calculate the weighted average number of shares based on the fact that 12 million were in issue throughout the year and 3 million for just seven months:

Weighted average number of shares

\[12m + \left(\frac{7}{12} \times 3m\right) = 13.75 \text{ million}\]

Profits attributable to ordinary shareholders have been generated using ordinary share capital available. Some of this capital was only available for seven months of the year, hence could only generate seven months' worth of profit. By adjusting the denominator of the EPS calculation to reflect that the shares were only in issue for seven months, we are ensuring that we compare like with like.

### 2.3.2 Partly-paid shares

Where shares are issued but not fully paid, they are included in the calculation of weighted average number of shares as a fraction of an ordinary share to the extent that they were entitled to participate in dividends during the period relative to a fully paid share. We'll take the previous example and adjust it to illustrate the point.

**Example**

Company A has a profit after tax of $20 million. The company had 12 million ordinary shares in issue at 1 January 20X3 and issued a further 3 million on 1 June 20X3 at the full market price. Half of the issue price has been paid for the new shares and until such time as the shares are fully paid, the shareholders are entitled to half of any dividend.

What is the basic earnings per share for the year ended 31 December 20X3?

**Solution**

<table>
<thead>
<tr>
<th></th>
<th>12,875,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings</td>
<td>$20 million</td>
</tr>
<tr>
<td>Weighted average number of shares</td>
<td></td>
</tr>
<tr>
<td>1 January 20X3 – 31 May 20X3</td>
<td>5 million</td>
</tr>
<tr>
<td>1 June 20X3 – 31 December 20X3</td>
<td>7.875 million</td>
</tr>
</tbody>
</table>

Therefore basic EPS

\[\frac{20,000,000}{12,875,000} = 155.34 \text{ cents}\]

### 2.3.3 Bonus issue

Where there is a bonus issue, the number of shares in issue increases however these are ‘free’ shares and there is no corresponding increase in resources available to the entity to use to make profits.

Therefore the number of ordinary shares outstanding before the event must be adjusted for the proportionate change in the number of shares outstanding as if the event had occurred at the beginning of the earliest period reported. It is also necessary to make adjustments to the prior period's EPS in order to make it comparable.
Example

Company B had a profit after tax of $16 million in the year ended 31 December 20X3. This increased to $19 million in the year ended 31 December 20X4. The company had 15 million ordinary shares in issue at 1 January 20X3 and 20X4 and issued a further 5 million on 1 July 20X4 by way of a 1 for 3 bonus issue.

What is the basic earnings per share for the year ended 31 December 20X3 and 20X4?

Solution

y/e 31 December 20X3 – as initially reported

| Earnings | $16 million |
| Weighted average number of shares | 15 million |
| Therefore basic EPS | 16,000,000/15,000,000 = 106.67 cents |

y/e 31 December 20X4

| Earnings | $19 million |
| Weighted average number of shares |
| 1 January 20X4 – 30 June 20X4 | 15m × 6/12 × 4/3* = 10 million |
| Bonus issue | 5m |
| 1 July 20X4 – 31 December 20X4 | 20m × 6/12 = 10 million |
| Therefore basic EPS | 19,000,000/20,000,000 = 95.00 cents |

*4/3 is the ‘bonus fraction’. It is calculated based on the number of shares in issue after the bonus issue over the number of shares in issue before the bonus issue. Here (15m + 5m)/15m = 20/15 = 4/3.

The bonus fraction is always applied to the number of shares prior to the bonus issue.

y/e 31 December 20X3 – adjusted EPS reported in 20X4 as comparative

The 20X3 EPS can be adjusted in two ways:

(i) By recalculating it with the weighted average number of shares as 20 million:

\[
\frac{16,000,000}{20,000,000} = 80.00 \text{ cents}
\]

(ii) By applying the reciprocal of the bonus fraction to the EPS originally calculated:

\[
106.67\text{c} \times \frac{3}{4} = 80.00 \text{ cents}
\]

2.3.4 Rights issue

A rights issue often involves issuing shares to existing shareholders in proportion to their existing shareholding at a price below the current market price.

For the purposes of calculating EPS this is treated as a combination of a bonus issue and an issue at fair value.

As with a bonus issue, a bonus fraction is used to calculate weighted average number of ordinary shares; this is calculated as:

\[
\frac{\text{Pre rights issue price of shares}}{\text{Theoretical ex-rights price (TERP)}}
\]
The TERP is calculated as:

\[
\text{TERP} = \frac{\text{Total market value of original shares pre rights issue} + \text{proceeds of rights issue}}{\text{Number of shares post rights issue}}
\]

This is the theoretical price at which the shares would trade after the rights issue.

As before, the bonus fraction is used to adjust the number of shares pre rights issue, and its reciprocal can be used to re-calculate the comparative EPS for the prior year.

**Example**

Company C had a profit after tax of $30 million in the year ended 31 December 20X3. This increased to $32 million in the year ended 31 December 20X4. The company had 25 million ordinary shares in issue at 1 January 20X3 and 20X4 and issued a further 5 million on 1 July 20X4 by way of a 1 for 5 rights issue. The market price of one share immediately before the rights issue was $4.50; the exercise price was $3.30.

What is the basic earnings per share for the year ended 31 December 20X3 and 20X4?

**Solution**

**y/e 31 December 20X3 – as initially reported**

<table>
<thead>
<tr>
<th>Earnings</th>
<th>$30 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weighted average number of shares</td>
<td>25 million</td>
</tr>
<tr>
<td>Therefore basic EPS</td>
<td>30,000,000</td>
</tr>
<tr>
<td></td>
<td>25,000,000</td>
</tr>
<tr>
<td></td>
<td>120.00 cents</td>
</tr>
</tbody>
</table>

**y/e 31 December 20X4**

<table>
<thead>
<tr>
<th>Earnings</th>
<th>$32 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weighted average number of shares</td>
<td></td>
</tr>
<tr>
<td>1 January 20X4 – 30 June 20X4</td>
<td>13,081,395</td>
</tr>
<tr>
<td>Rights issue</td>
<td></td>
</tr>
<tr>
<td>5m</td>
<td></td>
</tr>
<tr>
<td>1 July 20X4 – 31 December 20X4</td>
<td>28,081,395</td>
</tr>
<tr>
<td>30m × 6/12 × 4.5/4.3*</td>
<td></td>
</tr>
<tr>
<td>Therefore basic EPS</td>
<td>32,000,000</td>
</tr>
<tr>
<td></td>
<td>28,081,395</td>
</tr>
<tr>
<td></td>
<td>113.95 cents</td>
</tr>
</tbody>
</table>

*Bonus fraction  = \( \frac{4.50}{4.30} \)

** TERP  = \( \frac{(25 \times 4.50) + (5 \times 3.30)}{30} \)  =  \$4.30**

**y/e 31 December 20X3 – adjusted EPS reported in 20X4 as comparative**

(apply reciprocal of the bonus fraction)

120.00c  ×  4.3/4.5  =  114.67 cents
Example

Y Ltd reported a profit after tax of $28.5 million in the year ended 31 October 20X8. The profit of the previous year had been $24 million.

The following information relates to the share capital of the company:

- The company had 30 million ordinary shares of $30 million in issue at 31 October 20X7.
- 12 million 5% irredeemable preference shares of $12 million were issued on 1 January 20X7; there have been no further issues of this type of share.
- There was a 1 for 3 bonus issue of ordinary shares on 1 January 20X8.
- There was a 2 for 5 rights issue of ordinary shares on 1 May 20X8. The rights issue had an exercise price of $8.70; immediately before the issue the market price of one share was $9.82.

(a) What is the basic EPS for the year ended 31 October 20X7 as originally reported?
(b) What is the basic EPS for the year ended 31 October 20X8?
(c) What is the restated EPS for the year ended 31 October 20X7?

Solution

y/e 31 October 20X7 – as initially reported

| Earnings | (24m – (5% × $12m × 10/12m)) | $23.5 million |
| Weighted average number of ordinary shares | 30 million |
| Therefore basic EPS | 23,500,000 | 78.33 cents |

y/e 31 October 20X8

| Earnings | (28.5m – (5% × $12m)) | $27.9 million |
| Weighted average number of shares | |
| 1 Nov 20X7 – 31 Dec 20X7 | 30m × 2/12 × 4/3 × 9.82/9.5** | 6,891,228 |
| Bonus issue (1 for 3) | 10m |
| 1 Jan 20X8 – 30 Apr 20X8 | 40m × 4/12 × 9.82/9.5** | 13,782,456 |
| Rights issue (2 for 5) | 16m |
| 1 May 20X8 – 31 Oct 20X8 | 56m × 6/12 | 28,000,000 |
| Therefore basic EPS | 27,900,000 | 57.32 cents |

*Bonus fraction (bonus issue) = (30m + 10m)/30m = 4/3
** Bonus fraction (rights issue) = 9.82/9.5
*** TERP = (40m × $9.82) + (16m × $8.70) / 56m
= 9.50

y/e 31 October 20X7 – adjusted EPS (comparative for prior year in 20X8 financial statements)

78.33c × ¾ × 9.5/9.82 = 56.83 cents
SECTION SUMMARY

**Basic EPS** is calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period. Where a bonus or rights issue has taken place, a bonus fraction is applied to periods before the issue in calculating weighted average number of ordinary shares outstanding.

3 Diluted earnings per share

**SECTION INTRODUCTION**

**Diluted EPS** is calculated by adjusting the net profit attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares.

At the end of an accounting period, a company may have in issue some securities which do not (at present) have any ‘claim’ to a share of equity earnings, but may give rise to such a claim in the future. These include:

- **A separate class of ordinary shares** which at present is not entitled to any dividend, but will be entitled after some future date or event
- **Convertible loan stock** or **convertible preferred shares** which give their holders the right at some future date to exchange their securities for ordinary shares of the company, at a pre-determined conversion rate
- **Options** or **warrants** which entitle the holder to ordinary shares

In such circumstances, the number of ordinary shares in the future may increase, and this will affect the EPS. Depending on the instrument, conversion may impact one or both elements of the EPS calculation. For example the conversion of loan stock to ordinary shares will impact both:

- Profits attributable to ordinary shareholders increase as interest is no longer payable on the loan stock
- Weighted average number of ordinary shares increases as the loan stock has been converted into shares

### 3.1 Dilutive and anti-dilutive potential ordinary shares

The effect on earnings per share may be dilutive or anti-dilutive:

- **Dilutive potential ordinary shares** would decrease EPS on conversion because the number of shares ranking for dividend will increase but profits will not increase proportionately.
- **Anti-dilutive potential ordinary shares** would increase EPS on conversion because the number of shares ranking for dividend will increase but profits increase to a greater extent.

The calculation of diluted EPS takes only dilutive potential ordinary shares into account.
Example

Roan Holdings Ltd has a basic EPS of 111 cents. The company has $10,000,000 15% convertible loan stock in issue. This is convertible in the future at a rate of one share for every $10 loan stock. The company’s corporate income tax rate is 17%.

Here the effect of conversion would be:
- To increase earnings by $1,245,000 ($10m × 15% × (1–17%))
- To increase the number of shares by 1 million ($10m/$10)

The earnings per share for the conversion is therefore 124.50 cents (1,245,000/1,000,000). This is greater than basic earnings per share, meaning that the convertible loan stock is anti-dilutive and the impact of conversion would be to increase overall EPS.

3.1.1 Calculation of diluted EPS

Diluted earnings per share is calculated as:

\[
\frac{\text{Profits in basic EPS + effect on profit due to dilutive potential ordinary shares}}{\text{Number of shares in basic EPS + dilutive potential ordinary shares}}
\]

The calculation is performed in steps with each category of dilutive potential ordinary shares added in turn, starting with the most dilutive.

After each addition, diluted EPS is calculated and the diluted earnings per share figure is that which is the lowest calculated at any stage.

3.1.2 Earnings

The earnings calculated for basic EPS should be adjusted by the post-tax (including deferred tax) effect of the following.

(a) Any dividends on dilutive potential ordinary shares that were deducted to arrive at earnings for basic EPS
(b) Interest recognised in the period for the dilutive potential ordinary shares
(c) Any other changes in income or expenses (fees and discount, premium accounted for as yield adjustments) that would result from the conversion of the dilutive potential ordinary shares

The conversion of some potential ordinary shares may lead to changes in other income or expenses. For example, the reduction of interest expense related to potential ordinary shares and the resulting increase in net profit for the period may lead to an increase in the expense relating to a non-discretionary employee profit-sharing plan. When calculating diluted EPS, the net profit or loss for the period is adjusted for any such consequential changes in income or expense.

3.1.3 Number of shares

The number of ordinary shares is the weighted average number of ordinary shares calculated for basic EPS plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares.

It should be assumed that dilutive ordinary shares were converted into ordinary shares at the beginning of the period or, if later, at the actual date of issue. There are two other points.

(a) The computation assumes the most advantageous conversion rate or exercise rate from the standpoint of the holder of the potential ordinary shares.
(b) A **subsidiary, joint venture or associate** may issue potential ordinary shares that are convertible into either ordinary shares of the subsidiary, joint venture or associate, or ordinary shares of the reporting entity. If these potential ordinary shares have a dilutive effect on the consolidated basic EPS of the reporting entity, they are included in the calculation of diluted EPS.

### 3.2 Share options

The exercise of share options will not impact future profits, however will obviously increase the number of ordinary shares in issue.

Share options normally have an exercise price which is below the market price of a share. Therefore for the purposes of calculating diluted earnings per share, share options are treated as a hybrid of some shares issuable at full market price and a bonus issue. It is the **bonus issue element that is dilutive** and must be taken into account in the calculation of diluted EPS. It is assumed that all options will be exercised.

Where the exercise price of share options exceeds average market price in a period, the options are not dilutive.

**Example**

C Ltd reports a profit after tax of $17 million for the year ended 31 December 20X3. The company has 20m ordinary shares in issue and the average market price of these during the year ended 31 December 20X3 was $5. The company issued 500,000 share options on 1 January 20X3 and each of these entitles the holder to purchase one ordinary share at a cost of $3 between 1 July and 31 December 20X4.

What is diluted earnings per share for the year ended 31 December 20X3?

**Solution**

- The share options would raise $1.5 million (500,000 × $3) on exercise
- At average market price proceeds of $1.5 million equates to 300,000 shares ($1.5m/$5)
- Therefore the exercise of options is considered to be made up of:
  - 300,000 at average market price of $5
  - 200,000 bonus issue.

Diluted EPS is therefore

\[
\frac{17,000,000}{20,000,000 + 200,000} = 84.16\text{ cents}
\]

Note: Potential ordinary shares are always deemed to have been converted into ordinary shares at the start of the period.

Where share options have been issued to employees but some expenses have not yet been recognised in profit or loss in accordance with SFRS(I) 2 Share-based Payment, the expense not yet recognised is calculated on a ‘per option’ basis and added to the exercise price of the option in the diluted EPS calculation.

**Example**

In the above example, suppose that a $250,000 expense in respect of the share options has not yet been recognised in accordance with SFRS(I) 2.

What is diluted earnings per share for the year ended 31 December 20X3?
Solution

- Adjusted exercise price per share is $3.50 ($3 + (250,000/500,000))
- The share options would raise $1.75 million (500,000 × $3.50) on exercise
- At average market price proceeds of $1.75m equates to 350,000 shares ($1.75m/$5)
- Therefore the exercise of options is considered to be made up of:
  - 350,000 at average market price of $5
  - 150,000 bonus issue.

\[
\text{Diluted EPS is therefore } \frac{17,000,000}{20,000,000 + 150,000} = 84.37 \text{ cents}
\]

3.3 Convertible instruments

As we have already seen, convertible instruments may be dilutive or anti-dilutive. It is only the dilutive instruments which are taken into account in calculating diluted earnings per share.

Example

SA Ltd has a basic earnings per share of 67 cents for the year ended 31 August 20X3 based on 25 million shares and profits of $16.75m.

The company has in issue $5 million 4% loan stock which is convertible into ordinary shares at a rate of 15 per $100 in 20X7.

The tax rate applicable to SA Ltd is 17%.

What is diluted earnings per share for the year ended 31 August 20X3?

Solution

1. Assess whether convertible loan stock is dilutive or antidilutive:
   - Increase in profits on conversion: \(5m \times 4\% \times (100 - 17\%) = $166,000\)
   - Increase in shares on conversion: \(5m/100 \times 15 = 750,000\)
   - Earnings per share for convertible loan stock: \(166,000/750,000 = 22.13 \text{ cents}\)

This is lower than basic EPS and therefore the loan stock is dilutive.

2. Therefore diluted EPS is \(\frac{16,750,000 + 166,000}{25,000,000 + 750,000} = 65.69 \text{ cents}\)

Example

In 20X7 Balestier Properties Ltd had a basic EPS of 105 cents based on earnings after tax of $10,500,000 and 10m ordinary shares of $10 million. It also had in issue $400,000 15% Convertible Loan Stock which is convertible in two years' time at the rate of four ordinary shares for every $5 of stock. The rate of tax is 17%.

Required

Calculate the diluted EPS.
Solution

Diluted EPS is calculated as follows.

1. Number of shares: the additional equity on conversion of the loan stock will be 400,000/5 × 4 = 320,000 shares

2. Earnings: Balestier Properties Ltd will save post-tax interest payments of $49,800 (400,000 × 15% × (1–17%))

3. Earnings per share for the convertible instrument is 15.6 cents (49,800/320,000). This is lower than basic EPS and is therefore dilutive.

4. Therefore diluted EPS = \[ \frac{10,500,000 + 49,800}{10,000,000 + 320,000} = 102.23 \text{ cents} \]

Question 18.1

Prosperity Properties Ltd has 5,000,000 ordinary shares of $1.25 million in issue, and also had in issue in 20X4:

(a) $1,000,000 of 8.25% convertible loan stock, convertible in three years' time at the rate of 2 shares per $10 of stock.

(b) $2,000,000 of 10% convertible loan stock, convertible in one year's time at the rate of 3 shares per $5 of stock.

The total earnings after tax in 20X4 were $1,750,000.

The rate of income tax is 17%.

Required

Calculate the basic EPS and diluted EPS.
3.4 A summary of the approach to diluted EPS

The following flowchart shows how a diluted EPS calculation should be approached:

Are there any potential ordinary shares?

Yes

For each class of potential ordinary shares calculate:

1. The effect on profit, and
2. The effect on the number of shares if the potential ordinary shares are issued.

For each class of potential ordinary shares calculate an individual EPS based on the figures calculated in the previous step.

Consider each class of potential ordinary shares in turn. Is the individual EPS less than basic EPS for the entity?

No

The class of potential ordinary shares is anti-dilutive and is not relevant to the calculation of diluted EPS.

If all classes of potential ordinary shares are anti-dilutive, diluted EPS is equal to basic EPS.

Yes

These classes of potential ordinary share are dilutive. Order them from most dilutive to least dilutive.

Add each class of potential ordinary shares into the diluted EPS calculation in turn, starting with most dilutive. At each stage calculate a diluted EPS.

Fully diluted EPS is the lowest EPS at any stage of the calculation (this may arise before the effects of all dilutive potential ordinary shares are added in).
SECTION SUMMARY

**Diluted EPS** takes into account the dilutive effect of potential ordinary shares including those associated with options and convertible loans and preference shares. It is calculated by adjusting the net profit attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares. Anti-dilutive potential ordinary shares are ignored in the calculation of diluted EPS.

4 Presentation and disclosure

SECTION INTRODUCTION

Basic and diluted EPS must be presented in the financial statements of companies within the scope of SFRS(I) 1-33.

You should review the full disclosure requirements in SFRS(I) 1-33. A summary of the key points is given below.

An entity should present in the statement of profit or loss and other comprehensive income basic and diluted EPS for:

(a) Profit or loss from continuing operations attributable to the ordinary equity holders; and

(b) Profit or loss attributable to the ordinary equity holders for the period for each class of ordinary shares that has a different right to share in the net profit for the period.

Where two separate statements are presented showing profit or loss and other comprehensive income, EPS is shown in the statement of profit or loss only.

The basic and diluted EPS should be presented with *equal prominence* for all periods presented.

Basic and diluted EPS for any **discontinuing operations** must also be presented.

Disclosure must still be made where the EPS figures (basic and/or diluted) are **negative** (ie a loss per share).

In addition an entity must disclose:

(a) The profit attributable to ordinary shareholders used in the EPS and diluted EPS calculations and a reconciliation of this to profit for the period.

(b) The weighted average number of ordinary shares used in the EPS and diluted EPS calculations and a reconciliation of these amounts to each other.

(c) Instruments that could potentially dilute basic EPS but which are not included in the calculation of diluted EPS because they are anti-dilutive.

(d) Any transactions after the reporting date which would have changed significantly the number of ordinary shares or potential ordinary shares at the period end had the transactions occurred before that date.
Example

The following disclosure note is taken from the CapitaLand Ltd financial statements for 2017.

29 EARNINGS PER SHARE

(a) Basic earnings per share

<table>
<thead>
<tr>
<th></th>
<th>The Group</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2017</td>
</tr>
<tr>
<td></td>
<td>$'000</td>
</tr>
<tr>
<td>Basic earnings per share is based on:</td>
<td></td>
</tr>
<tr>
<td>Net profit attributable to owners of the Company</td>
<td>1,550,750</td>
</tr>
<tr>
<td>No. of shares ('000)</td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>4,245,629</td>
</tr>
<tr>
<td>2016</td>
<td>4,244,089</td>
</tr>
</tbody>
</table>

(b) Diluted earnings per share

In calculating diluted earnings per share, the profit attributable to owners of the Company and weighted average number of ordinary shares in issue during the year are adjusted for the effects of all dilutive potential ordinary shares:

<table>
<thead>
<tr>
<th></th>
<th>The Group</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2017</td>
</tr>
<tr>
<td></td>
<td>$'000</td>
</tr>
<tr>
<td>Net profit attributable to owners of the Company</td>
<td>1,550,750</td>
</tr>
<tr>
<td>Profit impact of conversion of the potential dilutive shares</td>
<td>60,898</td>
</tr>
<tr>
<td>Adjusted net profit attributable to owners of the Company</td>
<td>1,611,648</td>
</tr>
<tr>
<td>No. of shares ('000)</td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>4,245,629</td>
</tr>
<tr>
<td>2016</td>
<td>4,244,089</td>
</tr>
</tbody>
</table>

Adjustments for potential dilutive shares under:
- CapitaLand Performance Share Plan | 21,187 | 21,011 |
- CapitaLand Restricted Share Plan | 23,758 | 23,597 |
- Convertible bonds | 451,524 | 478,244 |

Weighted average number of ordinary shares used in the calculation of basic earnings per share | 4,742,098 | 4,766,941 |

4.1 Alternative EPS figures

An entity may present additional alternative EPS figures if it wishes. However, SFRS(I) 1-33 lays out certain rules where this takes place.

(a) The weighted average number of shares as calculated under SFRS(I) 1-33 must be used.
(b) A reconciliation must be given between the component of profit used in the alternative EPS (if it is not a line item in the statement of profit or loss and other comprehensive income) and the line item for profit reported in profit or loss.
(c) The entity must indicate the basis on which the numerator is determined.
(d) Basic and diluted EPS must be shown with equal prominence.

4.2 Significance of earnings per share

Earnings per share (EPS) is one of the most frequently quoted statistics in financial analysis. Because of the widespread use of the price earnings (P/E) ratio as a yardstick for investment decisions, it became increasingly important.

It seems that reported EPS can, through the P/E ratio, have a significant effect on a company’s share price. Therefore, a share price might fall if it looks as if EPS is going to be low. This is not very rational, as EPS can depend on many, often subjective, assumptions used in preparing a historical statement, namely the statement of profit or loss and other comprehensive income. It does not necessarily bear any relation to the value of a company, and of its shares. Nevertheless, the market is sensitive to EPS.

The following article is from The Straits Times:

Developers’ profit spikes may be due to accounting standard: OCBC

Melissa Tan
The Straits Times
Friday, Feb 07, 2014

INVESTORS take note: An accounting standard can make a huge difference to a developer’s bottom line.

The standard says developers can book profits from certain types of projects only upon completion of those projects – not profits racked up progressively.

Because of it, some second-liner property stocks could see earning spikes when they report their upcoming quarterly results, said OCBC Investment Research in a note yesterday.

It singled out developer Roxy-Pacific Holdings and construction firm Lian Beng Group for likely sharp net profit boosts.

Roxy-Pacific’s and Lian Beng’s predicted gains echo that of property developer Oxley Holdings last year.

Oxley’s profit for the three months to Sept 30 last year skyrocketed to a record $250.8 million from just $6.6 million the year before.

That gave a fillip to Oxley’s share price, sending it up by as much as 40 per cent after the results were announced.

The amount ‘almost matched the combined earnings of CapitaLand and City Developments, the two largest domestic developers, over that quarter’, OCBC said.

It explained that Oxley could post such a stunning surge because of the completion of its huge industrial development Oxley Bizhub last year.

The 728-unit Oxley Bizhub got its temporary occupation permit (TOP) during the July to September period and had all of its profits booked in that quarter.
Booking profits all at once upon completion is known as the 'completion of contract' profit recognition method. It is required for commercial, industrial and overseas projects, OCBC said.

It differs from the 'progressive profit recognition' accounting method usually used for domestic residential projects, where profits from a project are split up and recognised over a period of time.

OCBC said Roxy-Pacific and Lian Beng could see similar profit spikes ahead owing to the 'completion of contract' method.

Roxy-Pacific's completion of a mixed retail and office project at Changi called Wis@Changi could add $19.5 million to its earnings for the quarter ended Dec 31, OCBC said.

This forecast is based on an estimated selling price of $1,890 psf and a net saleable area of 40,716 sq ft. The gross floor area is 50,895 sq ft.

Wis@Changi has 23 shops and 60 office units and is fully sold. Roxy-Pacific bought the site at 116, Changi Road, for $35.5 million in late 2010.

Roxy is scheduled to report its fourth-quarter results on Feb 13.

Lian Beng is also likely to see net income for the three months to Feb 28 bumped up by the completion of M-Space, an industrial development at Mandai.

The 141-unit M-Space is fully sold and is set to contribute $18.3 million to Lian Beng's third-quarter earnings, OCBC said.

It is basing that on a selling price of $600 psf and a net saleable area of 171,282 sq ft. The project's industrial gross floor area is 180,297 sq ft.

Lian Beng holds a 55 per cent stake in the project and mainboard-listed dormitory operator Centurion Corporation owns the remaining 45 per cent.

Roxy-Pacific shares fell two cents to 55.5 cents and Lian Beng's counter lost half a cent to end at 52 cents yesterday.


**SECTION SUMMARY**

A publicly quoted entity must present in the statement of profit or loss and other comprehensive income basic and diluted EPS for profit or loss from continuing operations and profit or loss for the period for each class of ordinary share that has a different right to share in the net profit for the period.
Chapter Roundup

**SFRS(I) 1-33**

**Earnings per Share**

**Basic EPS**
- Profit (loss) after tax attributable to ordinary s/h
- Weighted average number of ordinary shares

**Diluted EPS**
- Basic EPS profit + effect of dilutive potential ordinary shares
- Basic EPS no. shares + dilutive potential ordinary shares

**Formulae for Diluted EPS**

1. Check whether potential ordinary shares are individually dilutive or anti-dilutive
2. Add dilutive potential ordinary shares into the calculation one at a time, most dilutive first
3. DEPS is the lowest calculated EPS figure at any stage in the calculations.
Quick Quiz

1. To which companies does SFRS(I) 1-33 apply?
2. How is basic earnings per share calculated?
3. How is the bonus fraction in respect of a bonus issue calculated?
4. How is the theoretical ex-rights price calculated?
5. Which potential ordinary shares are taken into account in the calculation of diluted EPS?
6. Where are basic and diluted earnings per share presented?
Answers to Quick Quiz

1. Those which are publicly traded, and entities where ordinary shares are in the process of being issued in public markets.

2. Proﬁts after tax attributable to ordinary shareholders
   Weighted average number of ordinary shares

3. Number of shares after the bonus issue
   Number of shares before the bonus issue

4. Total market value of original shares pre rights issue + proceeds of rights issue
   Number of shares post rights issue

5. Only those which are dilutive

6. On the face of the statement of proﬁt or loss and other comprehensive income (or the statement of proﬁt or loss where separate statements are prepared).

Answer to Question

18.1 EPS 1

(a) Basic EPS = \( \frac{1,750,000}{5 \text{ million}} \) = 35.00 cents

(b) Diluted EPS:

(i) assess whether convertible instruments are dilutive or antidilutive:

- 8.25% convertible loan stock
  \[ \frac{1,000,000 \times 8.25\% \times (1-17\%)}{1,000,000/10 \times 2} = \frac{68,475}{200,000} = 34.24 \text{ cents (dilutive)} \]

- 10% convertible loan stock
  \[ \frac{2,000,000 \times 10\% \times (1-17\%)}{2,000,000/5 \times 3} = \frac{166,000}{1,200,000} = 13.83 \text{ cents (dilutive)} \]

(ii) Calculate diluted earnings per share bringing each dilutive instrument into the calculation, one at a time, starting with the most dilutive.

Diluted EPS including 10% convertible loan stock:
\[ \frac{1,750,000 + 166,000}{5,000,000 + 1,200,000} = 30.90 \text{ cents} \]

Diluted EPS including 10% and 8.25% convertible loan stock:
\[ \frac{1,750,000 + 166,000 + 68,475}{5,000,000 + 1,200,000 + 200,000} = 31.01 \text{ cents} \]

Diluted EPS is therefore 30.9 cents as this is the lowest value calculated at any stage in the process.

Note that this presented ﬁgure does not include the effect of the 8.25% convertible loan stock, despite this being dilutive.
This chapter deals with two short standards: SFRS(I) 1-24 Related Party Disclosures and SFRS (I) 1-10 Events after the Reporting Period. SFRS(I) 1-24 is a disclosure standard which identifies related parties to a company and prescribes the necessary disclosures in respect of any transactions with them; SFRS(I) 1-10 is concerned with events that arise between the reporting date and the date on which the financial statements are approved and whether such events should be reflected in the financial statements.
In the absence of information to the contrary, it is assumed that a reporting entity has independent discretionary power over its resources and transactions and pursues its activities independently of the interests of its individual owners, managers and others. Transactions are presumed to have been undertaken on an arm's length basis, ie on terms such as could have been obtained in a transaction with an external party, in which each side bargained knowledgeably, willingly and freely, unaffected by any relationship between them.

These assumptions may not be justified when related party relationships exist, because the requisite conditions for competitive, free market dealings may not be present. While the parties may endeavour to achieve arm's length bargaining the very nature of the relationship may preclude this occurring.

1.1 Objective

SFRS(I) 1-24 tackles the related party issue by ensuring that financial statements contain the disclosures necessary to draw attention to the possibility that the reported financial position and results may have been affected by the existence of related parties and by material transactions with them. In other words, this is a standard which is primarily concerned with disclosure.
1.2 Scope

SFRS(I) 1-24:
(a) Identifies related party relationships and transactions
(b) Identifies outstanding balances between an entity and its related parties
(c) Identifies when related party transactions and balances should be disclosed
(d) Determines the disclosures to be made.

The standard requires disclosure of related party transactions and outstanding balances in the consolidated and separate financial statements of a parent, or investors with joint control of, or significant influence over, an investee presented in accordance with SFRS(I) 10 Consolidated Financial Statements or SFRS(I) 1-27 Separate Financial Statements as well as in individual financial statements.

An entity's financial statements disclose related party transactions and outstanding balances with other entities in a group. Intragroup transactions and balances are eliminated in the preparation of consolidated financial statements.

1.3 Definitions

The following important definitions are given by the standard. Note that the definitions of control and significant influence are now the same as given in SFRS(I) 10 Consolidated Financial Statements, SFRS(I) 1-28 Investments in Associates and Joint Ventures and SFRS(I) 11 Joint Arrangements.

**KEY TERMS**

**RELATED PARTY** A person or entity that is related to the entity that is preparing its financial statements.

(a) A person or a close member of that person's family is related to a reporting entity if that person:
   (i) Has control or joint control over the reporting entity;
   (ii) Has significant influence over the reporting entity; or
   (iii) Is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) An entity is related to a reporting entity if any of the following conditions applies:
   (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).
   (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
(iii) Both entities are joint ventures of the same third party.
(iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
(v) The entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
(vi) The entity is controlled or jointly controlled by a person identified in (a).
(vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).
(viii) The entity, or any member of a group of which it is part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

KEY TERMS

**RELATED PARTY TRANSACTION** A transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

**CONTROL** An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through power over the investee.

**SIGNIFICANT INFLUENCE** is the power to participate in the financial and operating policy decisions of an entity, but is not control or joint control over these policies.

**JOINT CONTROL** is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

**KEY MANAGEMENT PERSONNEL** are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

**CLOSE MEMBERS OF THE FAMILY OF A PERSON** are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity. They may include:
(a) That person’s children and spouse or domestic partner;
(b) Children of that person’s spouse or domestic partner; and
(c) Dependants of that person or that person’s spouse or domestic partner.

**GOVERNMENT** refers to government, government agencies and similar bodies whether local, national or international.

A **GOVERNMENT-RELATED ENTITY** is an entity that is controlled, jointly controlled or significantly influenced by a government. (SFRS(I) 1-24)

SFRS(I) 1-24 clarifies that in the definition of a related party, an associate includes subsidiaries of the associate and a joint venture includes subsidiaries of the joint venture.

The most important point to remember here is that, when considering each possible related party relationship, attention must be paid to the substance of the relationship, not merely the legal form.
SFRS(I) 1-24 lists the following which are not related parties.

(a) Two entities simply because they have a director or other key management in common or because a member of key management personnel of one entity has significant influence over the other entity.

(b) Two joint venturers, simply because they share joint control of a joint venture.

(c) Certain other bodies, simply as a result of their role in normal business dealings with the entity
   (i) Providers of finance
   (ii) Trade unions
   (iii) Public utilities
   (iv) Departments and agencies of a government that do not control, jointly control or significantly influence the reporting entity.

(d) A customer, supplier, franchisor, distributor, or general agent with whom the entity transacts a significant amount of business, simply by virtue of the resulting economic dependence.

SFRS(I) 1-24 does not define the term 'arm's length transaction'. However the following definition is provided in the Singapore Standards on Auditing (SSA) glossary:

'Arm's length transaction is a transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.'

1.4 Related party transactions

The standard lists some examples of transactions that are disclosed if they are with a related party:

- Purchases or sales of goods (finished or unfinished)
- Purchases or sales of property and other assets
- Rendering or receiving of services
- Leases
- Transfer of research and development
- Transfers under licence agreements
- Transfers under finance arrangements (including loans and equity contributions in cash or in kind)
- Provision of guarantees and collateral
- Settlement of liabilities on behalf of the entity or by the entity on behalf of that related party
- Commitments to do something if a particular event occurs or does not occur in the future, including executory contracts (recognised and unrecognised)

Questions arise as to what transactions are disclosable where the parties are related for only part of the year. Under SFRS(I) 1-24, disclosure is only required in respect of transactions during the period for which the entities are related.

The definition of related party transaction does not automatically imply that cash must change hands as it refers to resources, services and obligations. Guarantees and provisions of assets rent-free would therefore also be covered.

1.5 Disclosure

1.5.1 Parent–subsidiary relationship

Relationships between parents and subsidiaries must be disclosed irrespective of whether any transactions have taken place between the related parties. An entity must disclose the name of its parent and, if different, the ultimate controlling party. This will enable a reader of the financial statements to be able to form a view about the effects of a related party relationship on the reporting entity. It should be noted that the ultimate controlling party could be an individual, a group of individuals or an entity.
If neither the parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so shall also be disclosed.

1.5.2 Key management personnel compensation

An entity should disclose key management personnel compensation in total and for each of the following categories:

(a) Short-term employee benefits
(b) Post-employment benefits
(c) Other long-term benefits
(d) Termination benefits
(e) Share-based payments

If an entity obtains key management personnel services from another entity (known as a management entity), it need not make the disclosures listed above for compensation paid by the management entity to the management entity's employees or directors.

It should however disclose amounts paid to a separate management entity for the provision of key management personnel services.

1.5.3 Related party transactions

If an entity has had related party transactions in a period, the following disclosures should be made:

(a) The nature of the related party relationship
(b) The amount of the transactions
(c) The amount of outstanding balances, including commitments
(d) Provisions for doubtful debts related to outstanding balances
(e) The expense recognised in the period in respect of bad or doubtful debts from related parties

These disclosures should be made separately for each category of: the parent, entities with joint control or significant influence over the entity, subsidiaries, associates, joint ventures of the entity, key management personnel of the entity or its parent and other related parties.

Items of a similar nature may be disclosed in aggregate unless separate disclosure is necessary for an understanding of the effect on the financial statements.

Disclosures that related party transactions were made on terms equivalent to those that prevail in arm's length transactions are made only if such terms can be substantiated.

Example

The example of a related party transactions note below is taken from Pteris Global Ltd annual report 2017/18 for the financial year ended 31 March 2018.

RELATED PARTY TRANSACTIONS

In addition to the related party information disclosed elsewhere in the financial statements, the Group had the following significant transactions with its related parties at terms agreed between the parties:

(a) Sales and purchases of goods and services

<table>
<thead>
<tr>
<th></th>
<th>Group 2018 S$'000</th>
<th>Group 2017 S$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales and purchases of goods and services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Services rendered to an associated company</td>
<td>278,168</td>
<td>161,198</td>
</tr>
<tr>
<td>Services received from associated companies</td>
<td>(968)</td>
<td>(1,038)</td>
</tr>
<tr>
<td>Services rendered to related companies of a substantial shareholder</td>
<td>19,478</td>
<td>23,671</td>
</tr>
<tr>
<td>Services received from related companies of a substantial shareholder</td>
<td>(11,429)</td>
<td>(12,025)</td>
</tr>
<tr>
<td>Interest received from loans to associated companies</td>
<td>86</td>
<td>812</td>
</tr>
</tbody>
</table>
During the financial year ended 31 March 2018, the Company made payments on behalf of subsidiaries totalling S$50.2 million (2017: S$47.5 million) which were subsequently reimbursed.

Outstanding balances at 31 March 2018, arising from sale/purchase of goods and services, are unsecured and receivable/payable within 12 months from the end of the reporting period and are disclosed in Notes 14 and 24 respectively.

(b) **Key management personnel compensation**

Key management personnel compensation is as follows:

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and other short-term employee benefits</td>
<td>6,709</td>
<td>6,534</td>
</tr>
<tr>
<td>Post-employment benefits – contribution to CPF</td>
<td>98</td>
<td>68</td>
</tr>
<tr>
<td>Share-based staff costs</td>
<td>417</td>
<td>540</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>7,224</strong></td>
<td><strong>7,142</strong></td>
</tr>
</tbody>
</table>

Included in the above is total compensation to non-executive directors of the Company amounting to S$1,235,000 (2017: S$1,525,000).


---

### Question 19.1

Fragrant Flowers Ltd is a Singapore company which supplies floral arrangements to a chain of hotels. The company is also the sole importer of well-known vases from Hong Kong which are supplied to an upmarket shop in London's West End.

Fragrant Flowers was set up by a Singapore family and is now run by the matriarch.

The vases are purchased from the Hong Kong supplier by a Malaysian company, the shares of which are owned by the Fragrant Flowers Family Trust.

**Required**

Identify the financial accounting issues arising out of the above scenario.

---

### Question 19.2

Discuss whether the following events would require disclosure in the financial statements of the RP Group, a limited company, under SFRS(I) 1-24 *Related Party Disclosures*.

The RP Group, merchant bankers, has a number of subsidiaries, associates and joint ventures in its group structure. During the financial year to 31 October 20X9 the following events occurred.

(a) The company agreed to finance a management buyout of a group company, AB, a limited company. In addition to providing loan finance, the company has retained a 25% equity holding in the company and has a main board director on the board of AB. RP received management fees, interest payments and dividends from AB.

(b) On 1 July 20X9, RP sold a wholly owned subsidiary, X, a limited company, to Z, a public limited company. During the year RP supplied X with second-hand office equipment and X leased its factory from RP. The transactions were all contracted for at market rates.
The retirement benefit scheme of the group is managed by another merchant bank. An investment manager of the group retirement benefit scheme is also a non-executive director of the RP Group and received an annual fee for their services of $25,000 which is not material in the group context. The company pays $16m per annum into the scheme and occasionally transfers assets into the scheme. In 20X9, property, plant and equipment of $10m were transferred into the scheme and a recharge of administrative costs of $3m was made.

1.5.4 Exemption for government-related entities

SFRS(I) 1-24 includes an exemption for government-related entities. The exemption applies to an entity's related party transactions with:

(a) A government that has control, joint control or significant influence over the reporting entity

(b) Another entity that is a related party because the same government has control, joint control or significant influence over both the reporting entity and the other entity.

Where the exemption is applied, the entity must disclose the name of the government, nature of the relationship and information about transactions that are individually or collectively significant, in order to allow users to understand the effect of related party transactions on the financial statements.

This exemption eliminates the need to disclose information that is costly to gather, and of less value to users.

1.6 Practical considerations

With financial markets' evolution, the process of identifying and disclosing related party transactions has developed through time. However, in many companies there exists a serious lack of accounting systems to capture related party transactions for disclosure purposes.

Collection of the relevant information involves putting in place processes and controls over the processes:

1. The process may involve obtaining representations from relevant parties, such as key management personnel and shareholders who have substantial interests in the entity.

2. The process should also involve others who are likely to have knowledge of the entity's related party relationships and transactions, and the entity's controls over such relationships and transactions. These may include:

   - Personnel in a position to initiate, process, or record transactions that are both significant and outside the entity's normal course of business, and those who supervise or monitor such personnel
   - Internal auditors
   - In-house legal advisors

The entity's information system should record, process, and summarise related party relationships and transactions to enable the entity to meet the accounting and disclosure requirements of SFRS(I) 1-24.

1.6.1 SGX interested person requirements

For listed companies, there is another set of rules under the SGX Listing Manual in relation to disclosure and authorisation of interested person transactions that they must comply with. It is a common misconception that one equates to the other. The definitions of related parties and interested persons are independent of each other. There is overlap in the definitions which means a person or entity may be both a related party and an interested person. However, there is no direct relationship between the two definitions.
For example, persons who fall within both definitions include CEOs, directors, controlling shareholders and their spouse, child and parent. Siblings of CEOs, directors and controlling shareholders are considered interested persons but do not fall within the definition of a related party. Key management personnel who are not a CEO or a director of the entity are related parties but not interested persons. Accordingly, the processes and controls that are in place to identify transactions with interested persons may not be sufficient to identify related party transactions for disclosure in the financial statements.

SECTION SUMMARY

SFRS(I) 1-24 provides an extensive definition of related parties and requires that in applying it, attention is paid to the substance of a relationship and not merely its legal form. Disclosures are required in respect of parent-subsidiary relationships, key management personnel compensation and related party transactions.

2 SFRS(I) 1-10 Events after the Reporting Period

SECTION INTRODUCTION

SFRS(I) 1-10 Events after the Reporting Period identifies events arising between the reporting date and date on which the financial statements are authorised for issue as either adjusting or non-adjusting.

The objective of SFRS(I) 1-10 is to prescribe when an entity should adjust its financial statements for events after the reporting period and the disclosures that an entity should give about the date when the financial statements were authorised for issue and about events after the reporting period.

2.1 Definition

KEY TERM

Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

The process involved in authorising the financial statements for issue varies from entity to entity depending on a number of factors.

(a) Where an entity is required to submit its financial statements to shareholders for approval after they have been issued, the financial statements are authorised for issue on the date of issue (ie the date of the Statement by Directors pursuant to Section 201(15) of the Singapore Companies Act)

(b) Where an entity is required to issue its financial statements to a supervisory board made up of non-executive directors for approval, the financial statements are authorised for issue when the management authorises them for issue to the supervisory board

Events after the reporting period include all of those events up until the date when the financial statements are authorised for issue, even if public announcements of profit have been made before this.
2.2 Adjusting events

**KEY TERM**

**ADJUSTING EVENTS** are those events which provide evidence of conditions that existed at the end of the reporting period.

As the name suggests, amounts recognised in the financial statements are adjusted to reflect these events.

SFRS(I) 1-10 provides the following examples of adjusting events after the reporting period:

(a) The settlement after the reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period. In this case any previously recognised provision is adjusted or a new provision is recognised.

(b) The receipt of information after the reporting period indicating that an asset was impaired at the reporting date or that the amount of a previously recognised impairment loss needs to be adjusted. This information may be provided by:
   (i) The bankruptcy of a customer after the reporting date (which indicates that the carrying amount of a trade receivable should be adjusted)
   (ii) The sale of inventories at less than cost after the reporting date (which indicates that inventories should be measured at net realisable value rather than cost)
   (iii) The sale of a non-current asset for less than carrying amount after the reporting date (which indicates that an impairment should be recognised).

(c) The determination after the reporting period of the cost of assets purchased, or the proceeds from assets sold before the end of the reporting period

(d) The determination after the reporting period of the amount of profit-sharing or bonus payments, if the entity had a legal or constructive obligation at the end of the reporting period to make such payments as a result of events before that date

(e) The discovery of fraud or errors that show that the financial statements are incorrect

2.3 Non-adjusting events

**KEY TERM**

**NON-ADJUSTING EVENTS** are those events which are indicative of conditions that arose after the reporting period.

As the name suggests, amounts recognised in the financial statements are not adjusted to reflect these events.

Examples of non-adjusting events may include the following:

(a) The destruction of a non-current asset in the period after the reporting date due to fire or flood

(b) A decline in the fair value of investments after the reporting date due to circumstances arising after the reporting date

(c) A major business combination after the reporting period

(d) An announcement of a plan to discontinue an operation
(e) Purchases of assets, classification of non-current assets as held for sale (SFRS(I) 5), disposals of assets or expropriation of assets by government  
(f) An announcement of or commencement of a major restructuring  
(g) Share transactions after a reporting period  
(h) Abnormally large changes after the reporting period in foreign exchange rates  
(i) Changes in tax rates or tax laws enacted or announced after the reporting period  
(j) Entering into significant commitments  
(k) Commencing litigation due to events arising after the reporting period

SFRS(I) 1-10 is also clear that an equity dividend declared after the end of the reporting period is a non-adjusting event and should not be recognised as a liability. This is because there is no obligation at the reporting date; the obligation does not arise until the dividend is declared.

2.4 Going concern

Where an event after the reporting date results in going concern issues, for example, management decides that it intends to liquidate the business or cease trading or that it has no other choice but to either cease trading or liquidate the business or there is a deterioration in operating results or financial position, the financial statements should be presented to reflect this decision. Therefore, the going concern assumption is no longer appropriate and the financial statements should be adjusted and prepared on the break-up basis.

2.5 Disclosure

SFRS(I) 1-10 requires disclosures in respect of material non-adjusting events and details of the authorisation of the financial statements.

2.5.1 Material non-adjusting events

The following should be disclosed for each material category of non-adjusting event after the reporting period:

(a) The nature of the event; and  
(b) An estimate of its financial effect, or a statement that such an estimate cannot be made.

2.5.2 Authorisation of the financial statements

An entity must disclose the date when the financial statements were authorised for issue and who gave that authorisation.

If the entity's owners or others have the power to amend the financial statements after issue, the entity must also disclose that fact.

Example

The following subsequent events disclosure is taken from the 2017/2018 annual report of Singapore Airlines.

SUBSEQUENT EVENT

On 1 April 2018, SIA Cargo was successfully re-integrated to the Company. All assets and liabilities, other than cash balances, of SIA Cargo were transferred to the Company at their book values. The impact to the Company is a decrease of net assets of $940.4 million. There is no impact to the consolidated net assets of the Group.

On 6 April 2018, Scoot Tigerair Pte. Ltd (‘Scoot’), a subsidiary of the Company, raised $480 million via secured term loan from banks. The loan is secured on specific aircraft assets of Scoot and bears fixed interest of 2.924% per annum. The loan is repayable over 10 years.
2.5.3 Updating disclosures

If after the period end further information comes to light about conditions existing at the end of the period, any disclosures made should be updated in the light of this information.

2.6 Decision flowchart

The following flowchart demonstrates the approach that should be taken to events after the reporting date:

Has an event occurred between the reporting date and the date on which the financial statements are authorised for issue?

Yes

No

SFRS(I) 1-10 is not relevant

Does the event provide evidence of conditions that existed at the reporting date?

Yes

No

Does the event impact going concern?

Yes

Yes

Adjust the financial statements

No

No

Is the event material?

Yes

No

Disclose the nature of the event and its estimated financial effect

No adjustment or disclosure required

SECTION SUMMARY

Events after the reporting period are those events which occur between the reporting date and the date on which the financial statements are authorised for issue. They are classified as adjusting or non-adjusting events. Adjusting events are reflected in the financial statements; non-adjusting events are disclosed where they are material together with details of who authorised the financial statements for issue and the date on which this happened.
Chapter Roundup

SFRS(I) 1-24
Related Party Disclosures

Related parties
- Individuals
- Entities
- Apply substance over form

Related party transaction
Transfer of resources, services or obligations between a reporting entity and related party regardless of whether a price is charged

DISCLOSURE

Parent-subsidiary relationship
- Name of parent
- Name of ultimate controlling party

Key management personnel compensation
- In total for different types of compensation
- Not required for employees of a management entity that provides management services
- Must disclose amount paid to the management entity

Related party transactions in year
- Nature of relationship
- Amount of transactions
- Outstanding balances
- Provisions made
- Bad or doubtful debt expense
For each category of related party
Events that occur between the end of the reporting period and the date on which the financial statements are authorised for issue.

Adjusting events
- Provide evidence of conditions that existed at the reporting date
  - Adjust

Non-adjusting events
- Provide evidence of conditions that arose after the reporting period.
  - Affect going concern
  - Do not affect going concern but are material
  - Disclose
### Quick Quiz

1. What is a related party transaction?
2. A managing director of a company is a related party. True or false?
3. What categories of disclosure are required by SFRS(I) 1-24?
4. Is the sale of a non-current asset at less than carrying value after the period end an adjusting or non-adjusting event?
5. What disclosures are required in respect of non-adjusting events?
Answers to Quick Quiz

1. A transfer of resources, services or obligations between related parties.
2. True. He/She is part of the key management personnel.
3. Parent-subsidiary relationship; details of compensation paid to key management personnel; details of related party transactions.
4. Adjusting. It suggests that the asset was impaired at the reporting date.
5. The nature of the event and an estimate of its financial effect or a statement that such an estimate cannot be made.

Answers to Questions

19.1 Related parties

Issues
(a) The basis on which Fragrant Flowers trades with the Malaysian supplier company owned by the family trust.
(b) Whether the overseas companies trade on commercial terms with the Singapore company or do the foreign entities control the Singapore company.
(c) Does the nature of trade suggest a related party controls Fragrant Flowers? Detailed disclosures will be required in the accounts.

19.2 RP Group

(a) SFRS(I) 1-24 does not require disclosure of transactions between companies and providers of finance in the ordinary course of business. As RP is a merchant bank, no disclosure is needed between RP and AB. However, RP owns 25% of the equity of AB and it would seem significant influence exists (SFRS(I) 1-28 Investments in Associates and Joint Ventures, greater than 20% existing holding means significant influence is presumed) and therefore AB could be an associate of RP. SFRS(I) 1-24 regards associates as related parties.

The decision as to associate status depends upon the ability of RP to exercise significant influence especially as the other 75% of votes are owned by the management of AB.

Merchant banks tend to regard companies which would qualify for associate status as trade investments since the relationship is designed to provide finance.

SFRS(I) 1-24 presumes that a party owning or able to exercise control over 20% of voting rights is a related party. So an investor with a 25% holding and a director on the board would be expected to have significant influence over operating and financial policies in such a way as to inhibit the pursuit of separate interests. If it can be shown that this is not the case, there is no related party relationship.

The revised definition of a related party states that an entity which provides key management personnel services to the reporting entity is a related party. On the basis that RP Group receives management fees for this type of service a related party relationship would exist and the amount recognised as an expense should be disclosed.

If it is decided that there is a related party situation then all material transactions should be disclosed including management fees, interest, dividends and the terms of the loan.

Note:
There may be other disclosure requirements that the company has to consider eg SGX listing rules if the company is listed and the specific requirements of the Monetary Authority of Singapore (MAS) as the company is a merchant bank. (See http://www.mas.gov.sg/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Merchant-Banks.aspx)
(b) **SFRS(I) 1-24 does not require intra-group transactions and balances eliminated on consolidation to be disclosed.** SFRS(I) 1-24 does not deal with the situation where an undertaking becomes, or ceases to be, a subsidiary during the year.

Best practice indicates that related party transactions should be disclosed for the period when X was not part of the group. Transactions between RP and X should be disclosed between 1 July 20X9 and 31 October 20X9 but transactions prior to 1 July will have been eliminated on consolidation.

There is no related party relationship between RP and Z since it is a normal business transaction unless either party’s interests have been influenced or controlled in some way by the other party.

(c) **Employee retirement benefit schemes** of the reporting entity are included in the SFRS(I) 1-24 definition of **related parties**.

The contributions paid, the non-current asset transfer ($10m) and the charge of administrative costs ($3m) must be disclosed.

The pension investment manager would **not normally** be considered a related party. **However,** the manager is key management personnel by virtue of his non-executive directorship.

Directors are deemed to be related parties by SFRS(I) 1-24, and the manager receives a $25,000 fee. SFRS(I) 1-24 requires the disclosure of compensation paid to key management personnel and the fee falls within the definition of compensation. Therefore, it must be disclosed.
This chapter covers SFRS(I) 8 Operating Segments, which deals with the disclosure of information about an entity's operating segments and also about the entity's products and services, the geographical areas in which it operates and its major customers.
1 Introduction

An important aspect of reporting financial performance is segment reporting. This is covered by SFRS(I) 8 Operating Segments.

Large entities produce a wide range of products and services, often in several different countries. Further information on how the overall results of entities are made up from each of these product or geographical areas will help the users of the financial statements. This is the reason for segment reporting.

- The entity’s past performance will be better understood
- The entity's risks and returns may be better assessed
- More informed judgments may be made about the entity as a whole

Risks and returns of a diversified, multi-national company can only be assessed by looking at the individual risks and rewards attached to groups of products or services or in different groups of products or services or in different geographical areas. These may be subject to differing rates of profitability, opportunities for growth, future prospects and risks.

Segment reporting is covered by SFRS(I) 8 Operating Segments.

1.1 Objective

An entity must disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

1.2 Scope

Only entities whose equity or debt securities are publicly traded (ie on a stock exchange such as SGX) need disclose segment information. In group accounts, only consolidated segmental information needs to be shown. (The statement also applies to entities filing or in the process of filing financial statements for the purpose of issuing equity or debt instruments publicly.)
SECTION SUMMARY

SFRS(I) 8 provides guidance on disclosures in respect of operating segments. It applies to entities whose equity or debt securities are publicly traded.

2 Operating segments

SECTION INTRODUCTION

The definition of an operating segment is crucial to the standard.

KEY TERM

OPERATING SEGMENT This is a component of an entity:

(a) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity)

(b) Whose operating results are regularly reviewed by the entity’s chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and

(c) For which discrete financial information is available.  

(SFRS(I) 8)

Not every part of an entity is an operating segment. For example a corporate headquarters will not earn revenues and so is not an operating segment. However, a start-up operation may be an operating segment even though it has yet to earn any revenues.

The term ‘chief operating decision maker’ (CODM) identifies a function, not necessarily a manager with a specific title. That function is to allocate resources and to assess the performance of the entity’s operating segments. The CODM is usually the highest level of management (eg CEO or COO) but the function of the CODM may be performed by a group rather than one person (eg a board of directors, an executive committee or a management committee). An entity cannot have more than one CODM.

2.1 Aggregation

Two or more operating segments may be aggregated if the segments have similar economic characteristics, and the segments are similar in each of the following respects:

- The nature of the products or services
- The nature of the production process
- The type or class of customer for their products or services
- The methods used to distribute their products or provide their services, and
- If applicable, the nature of the regulatory environment
SECTION SUMMARY

An operating segment is a component of an entity that earns revenues and incurs expenses, whose results are regularly reviewed by the entity's CODM and for which discrete financial information is available. Operating segments may be aggregated for the purpose of applying the standard in some cases.

3 Reportable segments

SECTION INTRODUCTION

Operating segments are reportable where they meet quantitative thresholds.

An entity must report separate information about each operating segment that:

(a) Has been identified as meeting the definition of an operating segment; and

(b) Has a segment total of 10% or more of the total:

(i) Revenue (internal and external), or

(ii) In absolute amount of the greater of:

(1) The combined reported profit of all operating segments that did not report a loss; and

(2) The combined reported loss of all operating segments that reported a loss.

(iii) Assets

At least 75% of total external revenue must be reported by operating segments. Where this is not the case, additional segments must be identified (even if they do not meet the 10% thresholds).

Two or more operating segments below the thresholds may be aggregated to produce a reportable segment if the segments have similar economic characteristics, and the segments are similar in a majority of the aggregation criteria above.

Operating segments that do not meet any of the quantitative thresholds may be reported separately if management believes that information about the segment would be useful to users of the financial statements.
3.1 Decision tree to assist in identifying reportable segments

The following decision tree reproduced from SFRS(I) 8 IG will assist in identifying reportable segments.

Identify operating segments based on management reporting system

- Do some operating segments meet all aggregation criteria?
  - Yes: Aggregate segments if desired
  - No: Do some operating segments meet the quantitative thresholds?
    - Yes: Do some remaining operating segments meet a majority of the aggregation criteria?
      - Yes: Do identified reportable segments account for 75% of the entity’s revenue?
        - Yes: Report additional segment if external revenue of all segment is less than 75% of the entity’s revenue
          - No: Aggregate remaining segments into ‘all other segments’ category
        - No: Aggregate segments if desired
      - No: Do identified reportable segments account for 75% of the entity’s revenue?
        - Yes: Report additional segment if external revenue of all segment is less than 75% of the entity’s revenue
        - No: Aggregate remaining segments into ‘all other segments’ category
    - No: Aggregate segments if desired
  - No: These are reportable segment to be disclosed

Question 20.1

Jurong Leisure Ltd, a retail and leisure group, has three businesses operating in different parts of the world. Jurong Leisure reports to management on the basis of region. The results of the regional segments for the year ended 31 December 20X9 are as follows.

<table>
<thead>
<tr>
<th>Region</th>
<th>Revenue External $m</th>
<th>Revenue Internal $m</th>
<th>Segment profit/(loss) $m</th>
<th>Segment assets $m</th>
<th>Segment liabilities $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>200</td>
<td>3</td>
<td>(10)</td>
<td>300</td>
<td>200</td>
</tr>
<tr>
<td>North America</td>
<td>300</td>
<td>2</td>
<td>60</td>
<td>800</td>
<td>300</td>
</tr>
<tr>
<td>Other regions</td>
<td>500</td>
<td>5</td>
<td>105</td>
<td>2,000</td>
<td>1,400</td>
</tr>
</tbody>
</table>

There were no significant intra-group balances in the segment assets and liabilities. The retail outlets and leisure centres are located in capital cities in the various regions, and the company sets individual performance indicators for each retail outlet/leisure centre based on its city location.

Required

Discuss the principles in SFRS(I) 8 Operating Segments for the determination of a company’s reportable operating segments and how these principles would be applied for Jurong Leisure Ltd using the information given above.
SECTION SUMMARY

Operating segments are reportable where they have a segment total of 10% or more of total reported revenue, or the higher of the absolute amount of (i) total reported profit of profit-making segments or (ii) total reported loss of loss-making segments, or total assets. At least 75% of total external revenue must be reported by operating segments.

4 Disclosure

SECTION INTRODUCTION

SFRS(I) 8 has extensive disclosure requirements in respect of operating segment performance and position.

Disclosures required by SFRS(I) 8 are extensive, and best learned by looking at the example and proforma, which follow the list. The disclosures are categorised by SFRS(I) 8 as follows:

4.1 General information

The following general information should be disclosed:

(a) Factors used to identify the entity's reportable segments
(b) Judgments made by management in applying the aggregation criteria in SFRS(I) 8 paragraph 12
(c) Types of products and services from which each reportable segment derives its revenues

4.2 Information about profit or loss, assets and liabilities

- A measure of profit or loss must be reported for each reportable segment.
- A measure of total assets and liabilities is reported for each reportable segment only if these amounts are regularly provided to the CODM.

The following table details the items that should be disclosed in respect of these measures:

<table>
<thead>
<tr>
<th>Profit or loss</th>
<th>Assets and liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues from external customers</td>
<td>Investment in equity accounted associates and joint ventures</td>
</tr>
<tr>
<td>Revenues from internal transactions</td>
<td>Additions to non-current assets</td>
</tr>
<tr>
<td>Interest revenue*</td>
<td></td>
</tr>
</tbody>
</table>
### Profit or loss
- Interest expense*
- Depreciation and amortisation
- Material items of income and expense disclosed in accordance with SFRS(I) 1-1 *Presentation of Financial Statements*
- Interest in profit or loss of equity accounted associates and joint ventures
- Income tax expense or income
- Material non-cash amounts other than depreciation and amortisation

*Net interest revenue may be disclosed rather than separate interest revenue and interest expense where (i) a majority of the segment's revenue are from interest and (ii) the CODM relies primarily on net interest revenue to assess the performance of segments.

### 4.3 Reconciliations

A reconciliation of the total of each of the following items for the reportable segments to the entity's reported figures is required:

- (a) Revenue
- (b) Measure of profit or loss
- (c) Assets (if reported)
- (d) Liabilities (if reported)
- (e) Other material items of information.

All material reconciling items should be separately identified and described.

### 4.4 Entity-wide disclosures

The following entity-wide disclosures are relevant to all entities subject to SFRS(I) 8 if the relevant information is not provided as part of the reportable segment information given in section 4.2 of this chapter. Exemption is available from (a) and (b) if the information is not available and the cost to develop it would be excessive:

- (a) **External revenue** by each product and service
- (b) Geographical information:

```
Geographical areas -> External revenue (1) -> Non-current assets (2)

by:
- entity's country of domicile, and
- all foreign countries (subdivided if material)
```

**Notes:**

1. External revenue is allocated based on the customer's location.
2. Non-current assets excludes financial instruments, deferred tax assets, post-employment benefit assets, and rights under insurance contracts.

- (c) Information about **reliance on major customers** (i.e., those who represent more than 10% of external revenue). This can be difficult when involving government entities and the standard indicated that judgment may be required.
4.5 Other disclosure matters

4.5.1 Prior period segments

Reportable segments from the previous period that no longer meet the criteria should continue to be disclosed in the current period if management feel they are of continuing significance.

If new reporting segments are identified in the current period then the prior period’s segment information should be restated to show this segment (unless the information is not available and the cost to develop would be excessive).

4.5.2 Restatement of previously reported information

If an entity changes the internal structure of its organisation and the composition of reportable segments changes, information for the comparative period should be restated unless the information is not available and the cost to obtain this information is excessive.

If the information for the comparative period is not restated, information for the current period must be presented on both the old and new basis of segmentation unless the information is not available and the cost to develop it would be excessive.

4.6 Disclosure example from SFRS(I) 8

The following example is adapted from the Guidance on implementing SFRS(I) 8 Operating Segments, which emphasises that this is for illustrative purposes only and that the information must be presented in the most understandable manner in the specific circumstances.

The hypothetical company does not allocate tax expense (tax income) or non-recurring gains and losses to reportable segments. In addition, not all reportable segments have material non-cash items other than depreciation and amortisation in profit or loss. The amounts in this illustration, denominated as dollars, are assumed to be the amounts in reports used by the CODM.

<table>
<thead>
<tr>
<th>Car parts</th>
<th>Motor vessel</th>
<th>Software</th>
<th>Electronics</th>
<th>Finance</th>
<th>All other</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>$3,000</td>
<td>$5,000</td>
<td>$9,500</td>
<td>$12,000</td>
<td>$5,000</td>
<td>$1,000</td>
<td>$35,500</td>
</tr>
<tr>
<td>Intersegment revenues</td>
<td>–</td>
<td>–</td>
<td>3,000</td>
<td>1,500</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Interest revenue</td>
<td>450</td>
<td>800</td>
<td>1,000</td>
<td>1,500</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Interest expense</td>
<td>350</td>
<td>600</td>
<td>700</td>
<td>1,100</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Net interest revenue</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>1,000</td>
<td>–</td>
</tr>
<tr>
<td>Depreciation and amortisation</td>
<td>200</td>
<td>100</td>
<td>50</td>
<td>1,500</td>
<td>1,100</td>
<td>–</td>
</tr>
<tr>
<td>Reportable segment profit</td>
<td>200</td>
<td>70</td>
<td>900</td>
<td>2,300</td>
<td>500</td>
<td>100</td>
</tr>
</tbody>
</table>

| Other material non-cash items: | |
| Impairment of assets | – | 200 | – | – | – | – | 200|
| Reportable segment assets | 2,000 | 5,000 | 3,000 | 12,000 | 57,000 | 2,000 | 81,000|
| Expenditure for reportable segment non-current assets | 300 | 700 | 500 | 800 | 600 | – | 2,900|
| Reportable segment liabilities | 1,050 | 3,000 | 1,800 | 8,000 | 30,000 | – | 43,850|

(a) Revenues from segments below the quantitative thresholds are attributable to four operating segments of the company. Those segments include a small property business, an electronics equipment rental business, a software consulting practice and a warehouse leasing operation. None of those segments has ever met any of the quantitative thresholds for determining reportable segments.
(b) The finance segment derives a majority of its revenue from interest. Management primarily relies on net interest revenue, not the gross revenue and expense amounts, in managing that segment. Therefore, as permitted by SFRS(I) 8 para 23, only the net amount is disclosed.

4.7 Suggested proforma

Information about profit or loss, assets and liabilities

<table>
<thead>
<tr>
<th></th>
<th>Segment A</th>
<th>Segment B</th>
<th>Segment C</th>
<th>All other segments</th>
<th>Inter segment</th>
<th>Entity total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue – external customers</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>–</td>
<td>X</td>
</tr>
<tr>
<td>Revenue – inter segment</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>–</td>
</tr>
<tr>
<td>Interest revenue</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>(X)</td>
<td>X</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(X)</td>
<td>(X)</td>
<td>(X)</td>
<td>(X)</td>
<td>X</td>
<td>(X)</td>
</tr>
<tr>
<td>Depreciation and amortisation</td>
<td>(X)</td>
<td>(X)</td>
<td>(X)</td>
<td>(X)</td>
<td>–</td>
<td>(X)</td>
</tr>
<tr>
<td>Other material non-cash items</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
</tr>
<tr>
<td>Material income/expense (SFRS(I) 1-1)</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
</tr>
<tr>
<td>Share of profit of associate/JVs</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>–</td>
<td>X</td>
</tr>
<tr>
<td>Segment profit before tax</td>
<td>(X)</td>
<td>(X)</td>
<td>(X)</td>
<td>(X)</td>
<td>X</td>
<td>(X)</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(X)</td>
<td>(X)</td>
<td>(X)</td>
<td>(X)</td>
<td>–</td>
<td>(X)</td>
</tr>
<tr>
<td>Unallocated items</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
<td>X/(X)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>(X)</td>
<td>X</td>
</tr>
</tbody>
</table>

Segment assets
Investments in associate/JVs
Unallocated assets
Entity’s assets
Expenditures for reportable assets
Segment liabilities
Unallocated liabilities
Entity’s liabilities

Information about geographical areas

<table>
<thead>
<tr>
<th></th>
<th>Country of domicile</th>
<th>Foreign countries</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue – external customers</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Non-current assets</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

An example of the disclosure as required by SFRS(I) 8 can be found in the Singapore Airlines Annual Report 2017/18 Note 4 pgs 127–132. You can access this information at the following web address: https://www.singaporeair.com/saar5/pdf/Investor-Relations/Annual-Report/annualreport1718.pdf
SECTION SUMMARY

SFRS(I) 8 disclosures are of:

- Operating segment profit or loss
- Segment assets (where these are reported to the CODM)
- Segment liabilities (where these are reported to the CODM)
- Certain income and expense items

Disclosures are also required about the revenues derived from products or services and about the countries in which revenues are earned or assets held, even if that information is not used by management in making decisions.

5 Criticisms of SFRS(I) 8

SECTION INTRODUCTION

There are a number of criticisms of SFRS(I) 8.

(a) Some commentators have criticised the ‘management approach’ to identifying reportable segments as leaving segment identification too much to the discretion of the entity and being too subjective.

(b) The management approach may mean that financial statements of different entities are not comparable.

(c) Management may report segments which are not consistent for internal reporting and control purposes, making its usefulness questionable.

(d) Only limited geographical information is provided.

(e) There is no defined measure of segment profit or loss.

SECTION SUMMARY

Criticisms of SFRS(I) 8 include the fact that the managerial approach to identifying reportable segments is too subjective and means that the financial statements of different entities are not comparable.
Chapter Roundup

SFRS(I) 8 Operating Segments

Aggregate if meet aggregation criteria

Operating Segments

Business activities to earn revenue/incur expenses

Results reviewed by CODM

Discrete financial information is available

Total revenue or

Profit/loss or

Assets

Add in segments below threshold if necessary

Reportable if segment total ≥ 10%

Total reportable segments must represent >75% external revenue

Disclosures

General information

Segment profit/loss/assets/liabilities

Reconciliations

Entity wide disclosures
Quick Quiz

1 All entities must disclose segment information. True or false?
2 How is an operating segment defined?
3 What quantitative thresholds must be met in order for an operating segment to be reportable?
4 What information should be disclosed in respect of segmental assets and liabilities?
Answers to Quick Quiz

1. False. Only entities whose equity or debt securities are publicly traded need disclose segment information.

2. An operating segment is a component of an entity:
   (a) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity)
   (b) Whose operating results are regularly reviewed by the entity’s CODM to make decisions about resources to be allocated to the segment and assess its performance, and
   (c) For which discrete financial information is available.

3. An operating segment is reportable where its totals are 10% or more of the entity totals in respect of any of:
   (a) Revenue, both external and internal
   (b) Absolute amount of the greater of total profits or total losses
   (c) Assets

4. Segment assets and segment liabilities should be disclosed where this information is provided to the CODM as well as:
   • Investments in equity accounted associates and joint ventures
   • Additions to non-current assets

Answer to Question

20.1 SFRS(I) 8

SFRS(I) 8 Operating Segments states that an operating segment is reported separately if:

(i) It meets the definition of an operating segment, ie:
   (1) It engages in business activities from which it may earn revenues and incur expenses,
   (2) Its operating results are regularly reviewed by the entity’s CODM to make decisions about resources to be allocated to the segment and assess its performance, and
   (3) Discrete financial information is available for the segment,

and

(ii) It meets at least one of the following quantitative thresholds:
   (1) Reported revenue is 10% or more of the combined revenue of all operating segments (external and intersegment), or
   (2) The absolute amount of its reported profit or loss is 10% or more of the greater of, in absolute amount, all operating segments not reporting a loss, and all operating segments reporting a loss, or
   (3) Its assets are 10% or more of the total assets of all operating segments.

At least 75% of total external revenue must be reported by operating segments. Where this is not the case, additional segments must be identified (even if they do not meet the 10% thresholds).

Two or more operating segments below the thresholds may be aggregated to produce a reportable segment if the segments have similar economic characteristics, and the segments are similar in a majority of the following aggregation criteria:

(a) The nature of the products and services
(b) The nature of the production process
(c) The type or class of customer for their products or services
(d) The methods used to distribute their products or provide their services
(e) If applicable, the nature of the regulatory environment
Operating segments that do not meet any of the quantitative thresholds may be reported separately if management believes that information about the segment would be useful to users of the financial statements.

For Jurong Leisure, the thresholds are as follows.

(a) Combined revenue is $1,010 million, so 10% is $101 million.
(b) Combined reported profit is $165 million, so 10% is $16.5 million.
(c) Combined reported loss is $10 million, so 10% is $1 million.
(d) Total assets are $3,100 million, so 10% is $310 million.

From (b) and (c), as (b) is greater, 'total profits (sum of profits by profit-making segments)' is used as the criterion to calculate the 10% threshold. Therefore $16.5 million is used as the threshold. The North America segment meets the criteria, passing all three tests. Its combined revenue is $302 million; its reported profit is $60 million, and its assets are $800 million.

The Asian segment also meets the criteria, but only marginally. Its reported revenue, at $203 million is greater than 10% of combined revenue, and only one of the tests must be satisfied. However, its loss of $10 million is less than the greater of 10% of combined profit (which is $16.5 million) and 10% of combined loss, so it fails this test. It also fails the assets test, as its assets, at $300 million are less than 10% of combined assets ($310 million).

SFRS(I) 8 requires further that at least 75% of total external revenue must be reported by operating segments. Currently, only 50% is so reported. Additional operating segments (the 'other regions') must be identified until this 75% threshold is reached.

SFRS(I) 8 may result in a change to the way Jurong Leisure's operating segments are reported, depending on how segments were previously identified.
Separate analysis of discontinued operations and of non-current assets held for sale allows the user of the accounts to make more accurate assessments of a company’s prospects in the future, because it excludes these items.

**Topic list**

1. SFRS(I) 5 *Non-current Assets Held for Sale and Discontinued Operations*
2. Classification of non-current assets (or disposal groups) held for sale
3. Measurement of non-current assets held for sale
4. Presentation of assets held for sale
5. Discontinued operations
21: Discontinued operations and assets held for sale

**Syllabus Handbook**

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measurement and Reporting (assets)</strong></td>
<td>3</td>
</tr>
<tr>
<td>Apply, explain and evaluate accounting standards for major classes of assets, insofar as they affect initial recognition, measurement (including initial measurement and subsequent re-measurement), classification and disclosure, and de-recognition from an entity's statement of financial position.</td>
<td>3</td>
</tr>
<tr>
<td><strong>Specific Applications</strong></td>
<td>3</td>
</tr>
<tr>
<td>Apply the relevant accounting treatment on the following classes of assets:</td>
<td></td>
</tr>
<tr>
<td>• Assets held for sale</td>
<td></td>
</tr>
<tr>
<td><strong>Continuing and Discontinued Interests</strong></td>
<td>3</td>
</tr>
<tr>
<td>Prepare group financial statements where activities have been discontinued or have been acquired or disposed of in a period.</td>
<td></td>
</tr>
<tr>
<td><strong>Emerging Trends</strong></td>
<td>1</td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments.</td>
<td></td>
</tr>
</tbody>
</table>

**ESSENTIAL READING**

SFRS(I) 5 *Non-current Assets Held for Sale and Discontinued Operations*,
SFRS(I) 5 *Implementation Guidance*

1. **SFRS(I) 5 Non-current Assets Held for Sale and Discontinued Operations**

**SECTION INTRODUCTION**

SFRS(I) 5 deals with the measurement and presentation of non-current assets which a company intends to sell rather than use and the presentation of the results of discontinued operations.

IFRS 5 was the result of a short-term convergence project with the US Financial Accounting Standards Board (FASB). It was adopted by the Singapore ASC as FRS 105 in 2004, and as SFRS(I) 5 in 2017.

SFRS(I) 5 requires non-current assets and groups of assets that are 'held for sale' to be presented separately in the statement of financial position and the results of discontinued operations to be presented separately in the statement of profit or loss and other comprehensive income. This is required so that users of financial statements will be better able to make projections about the financial position, profits and cash flows of the entity.
SFRS(I) 5 refers to a group of assets which are held for sale as a ‘disposal group’.

KEY TERM

**DISPOSAL GROUP** A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a cash-generating unit to which goodwill has been allocated in accordance with the requirements of paragraphs 80–87 of FRS 36 *Impairment of Assets* (as revised in 2004) or if it is an operation within such a cash-generating unit. (SFRS(I) 5)

(In practice, a disposal group could be a subsidiary, a cash-generating unit or a single operation within an entity.)

SFRS(I) 5 does not apply to certain assets covered by other accounting standards:

- (a) Deferred tax assets (SFRS(I) 1-12)
- (b) Assets arising from employee benefits (SFRS(I) 1-19)
- (c) Financial assets (SFRS(I) 9)
- (d) Investment properties accounted for in accordance with the fair value model (SFRS(I) 1-40)
- (e) Agricultural and biological assets that are measured at fair value less estimated point of sale costs (SFRS(I) 1-41)
- (f) Insurance contracts (SFRS(I) 4 or SFRS(I) 17)

SECTION SUMMARY

SFRS(I) 5 requires assets and groups of assets that are ‘held for sale’ to be presented separately in the statement of financial position and the results of discontinued operations to be presented separately in the statement of profit or loss and other comprehensive income.

2 Classification of non-current assets (or disposal groups) held for sale

SECTION INTRODUCTION

A non-current asset or disposal group is only classified as held for sale if it meets specific SFRS(I) 5 criteria.

2.1 Non-current assets or disposal groups

A non-current asset (or disposal group) should be classified as **held for sale** if its carrying amount will be recovered **principally through a sale transaction** rather than **through continuing use**. A number of detailed criteria must be met:

- (a) The asset must be **available for immediate sale** in its present condition.
- (b) Its sale must be **highly probable** (ie, significantly more likely than not).
For the sale to be highly probable, the following must apply.

(a) Management must be committed to a plan to sell the asset.
(b) There must be an active programme to locate a buyer.
(c) The asset must be marketed for sale at a price that is reasonable in relation to its current fair value.
(d) The sale should be expected to take place within one year from the date of classification.
(e) It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Where an entity is committed to a sale plan involving a loss of control of a subsidiary, all of the assets and liabilities of the subsidiary are classified as held for sale even where the entity intends to retain a non-controlling interest.

An asset (or disposal group) can still be classified as held for sale, even if the sale has not actually taken place within one year. However, the delay must have been caused by events or circumstances beyond the entity's control and there must be sufficient evidence that the entity is still committed to sell the asset or disposal group. Otherwise the entity must cease to classify the asset as held for sale.

If an entity acquires a disposal group (eg, a subsidiary) exclusively with a view to its subsequent disposal it can classify the asset as held for sale only if the sale is expected to take place within one year and it is highly probable that all the other criteria will be met within a short time following the acquisition (normally three months).

An asset that is to be abandoned should not be classified as held for sale. This is because its carrying amount will be recovered principally through continuing use. However, a disposal group to be abandoned may meet the definition of a discontinued operation and therefore separate disclosure may be required (see below).

Example

Shenton Commercial Ltd acquired a property on 31 August 20X3 comprising land and buildings that it intended to sell. The property was renovated during September and October 20X3 and classified as held for sale in the financial statements at 31 December 20X3. At this date a buyer had not been found. In January 20X4, Shenton Commercial became aware of environmental damage to the property which required remediation. The property cannot be transferred to a buyer until remediation is completed.

What effect, if any does the damage have on the classification of the property?

Solution

The requirement to repair the damage prior to any sale demonstrates that the property is not available for immediate sale. Therefore in January 20X4 the SFRS(I) 5 criteria are no longer met and the property must be reclassified as held and used. See consequential accounting treatment for changes to a plan of sale in Section 3.4 below.

Question 21.1

On 1 December 20X3, a company became committed to a plan to sell a manufacturing factory and has already found a potential buyer. The company does not intend to discontinue the operations currently carried out in the factory. At 31 December 20X3 there is a backlog of uncompleted customer orders. The subsidiary will not be able to transfer the factory to the buyer until after it ceases to operate the facility and has eliminated the backlog of uncompleted customer orders. This is not expected to occur until early 20X4.

Required

Should the manufacturing factory be classified as ‘held for sale’ at 31 December 20X3?
2.2 Assets held for distribution to owners

A non-current asset (or disposal group) is classified as held for distribution to owners when the entity is committed to distribute the asset (or disposal group) to the owners.

For this to be the case:

- The assets must be available for immediate distribution in their present condition; and
- The distribution must be highly probable.

For the distribution to be highly probable:

(a) Actions to complete the distribution must have been initiated
(b) These actions should be expected to be completed within one year from the date of classification.

SFRS(I) 5 requires that assets held for distribution to owners are accounted for in the same way as assets held for sale.

SECTION SUMMARY

An asset or disposal group is classified as held for sale when it is available for immediate sale in its present condition and the sale is highly probable. A sale is highly probable where management are committed to a sale plan, there is an active programme to locate a buyer, the price at which the asset or disposal group is marketed is reasonable in relation to fair value, sale is expected within one year and it is unlikely that the sale plans will change.

3 Measurement of non-current assets held for sale

SECTION INTRODUCTION

SFRS(I) 5 provides the measurement requirements for non-current assets and disposal groups held for sale.

3.1 Initial measurement

Immediately before classification the carrying amount of the asset (or assets and liabilities in the disposal group) must be measured in accordance with applicable SFRS(I)s.

On transfer to the held for sale category the non-current asset (or disposal group) should be measured at the lower of its carrying amount and fair value less costs to sell.

Non-current assets (or disposal groups) classified as held for distribution to owners are measured at the lower of carrying amount and fair value less costs to distribute.
### Key Terms

**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 (SFRS(I) 13).

**Costs to Sell** The incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and income tax expense.

**Recoverable Amount** The higher of an asset's fair value less costs to sell and its value in use.

**Value in Use** The present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

#### 3.1.1 Recognition of Impairment Losses

An impairment loss should be recognised where fair value less costs to sell (or distribute) is lower than carrying amount. Note that this is an exception to the normal rule. SFRS(I) 1-36 *Impairment of Assets* requires an entity to recognise an impairment loss only where an asset's recoverable amount is lower than its carrying value. Recoverable amount is defined as the higher of net realisable value and value in use. SFRS(I) 1-36 does not apply to non-current assets held for sale.

#### 3.1.2 Disposal Groups and Impairment Losses

SFRS(I) 5 (paragraph 23) states that impairment losses for a disposal group will reduce the carrying amount of the non-current assets in the group that are within the scope of the measurement requirements of this SFRS(I), in the order of allocation set out in SFRS(I) 1-36 paragraphs 104(a), 104(b) and 122. This means that the impairment is set against any goodwill in the disposal group first, and then against other non-current assets on a pro rata basis.

### Example

On 1 January 20X4 B Ltd decides to dispose of a division of its business and at that date it meets the conditions to be classified as held for sale in accordance with SFRS(I) 5. The disposal group is made up of the following assets at 1 January 20X4:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>700,000</td>
</tr>
<tr>
<td>Other intangible assets</td>
<td>2,200,000</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>4,400,000</td>
</tr>
<tr>
<td>Current assets</td>
<td>2,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>9,300,000</strong></td>
</tr>
</tbody>
</table>

The fair value less costs to sell of the disposal group is $7,800,000.

Calculate the impairment on classification as held for sale and explain how the impairment will be allocated.

### Solution

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment (9,300,000 – 7,800,000)</td>
<td>1,500,000</td>
</tr>
</tbody>
</table>

This will be allocated to goodwill and then the remainder against the other non-current assets on a pro rata basis. No impairment will be set off against current assets.
3.2 Subsequent measurement

Non-current assets held for sale and non-current assets that are part of a disposal group held for sale should not be depreciated, even if they are still being used by the entity. Interest and other expenses attributable to the liabilities of a disposal group held for sale continue to be recognised.

**Example**

B Ltd has an item of plant which originally cost $880,000. The asset is being depreciated over ten years on a straight-line basis with no residual value. On 1 January 20X4 the carrying value of the plant is $620,000. On 30 March 20X4 B Ltd decides to sell the plant and at that date it meets the conditions to be classified as held for sale in accordance with SFRS(I) 5. The market value of the plant at 30 March 20X4 is $600,000 and costs to sell are estimated as $30,000.

What will be the carrying amount of the plant in the statement of financial position at 31 December 20X4? (Assume that the asset is not sold at the end of the reporting period and that there are no changes to fair value.)

**Solution**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount at the date of transfer</td>
<td>598,000</td>
</tr>
<tr>
<td>(620,000 – (880,000/10 × 3/12))</td>
<td></td>
</tr>
<tr>
<td>Fair value less costs to sell</td>
<td>570,000</td>
</tr>
<tr>
<td>(600,000 – 30,000)</td>
<td></td>
</tr>
<tr>
<td>Impairment</td>
<td>28,000</td>
</tr>
</tbody>
</table>

The asset is transferred to the held for sale category at the lower of the carrying amount ($598,000) and fair value less costs to sell ($570,000) and an impairment is recognised of $28,000 in profit or loss. The asset will be shown in the statement of financial position at $570,000 as no depreciation is charged after the asset has been transferred.

3.2.1 Subsequent reporting dates

At each reporting date subsequent to classification as held for sale (or distribution) an asset (or disposal group) is remeasured to the lower of carrying amount and fair value less costs to sell (or distribute).

In the case of a disposal group, determining carrying amount first requires that assets and liabilities outside the scope of SFRS(I) 5 are remeasured in accordance with applicable standards.

An impairment loss is recognised where:

(a) Initial measurement was at carrying amount and fair value less costs to sell (or distribute) has now fallen below carrying amount; or
(b) Initial measurement was at fair value less costs to sell (or distribute) and this measurement has decreased.
In some cases an asset or disposal group is measured at fair value less costs to sell (or distribute) on initial classification as held for sale (or distribution) and that fair value less costs to sell (or distribute) subsequently increases. In this case:

(a) In respect of an asset a gain is recognised, however not in excess of the cumulative impairment loss recognised in accordance with SFRS(I) 5 or previously in accordance with SFRS(I) 1-36.

(b) In respect of a disposal group, a gain is recognised:

(i) To the extent it is not recognised on the remeasurement of the carrying amount of assets and liabilities outside the scope of SFRS(I) 5; and

(ii) For assets within the scope of the measurement requirements of SFRS(I) 5, not in excess of the cumulative impairment loss recognised in accordance with SFRS(I) 5 or previously in accordance with SFRS(I) 1-36.

Example

Quay Developments Ltd classified one of its divisions as a disposal group held for sale on 31 August 20X6. On this date the fair value less costs to sell was determined to be $500,000 less than its carrying amount and this loss was allocated as follows:

<table>
<thead>
<tr>
<th>Carrying amount at 31 August 20X6</th>
<th>Impairment loss</th>
<th>Revised carrying amount at 31 August 20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>400</td>
<td>(400)</td>
</tr>
<tr>
<td>Non-current assets</td>
<td>1,900</td>
<td>(100)</td>
</tr>
<tr>
<td>Current assets</td>
<td>340</td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td>(120)</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>2,520</td>
<td></td>
</tr>
</tbody>
</table>

At the year end of 31 December 20X6, the division had not yet been sold. The current assets of the division were measured at $325,000 and the current liabilities at $100,000. The fair value less costs to sell of the division was $2.2 million.

Calculate amounts to be recognised in the statement of financial position of Quay developments at 31 December 20X6 in respect of the disposal group and explain your answer.

Solution

The statement of financial position of Quay Developments Ltd at 31 December 20X6 will include:

- Assets held for sale of $2,225,000
- Liabilities associated with assets held for sale of $100,000

Working

<table>
<thead>
<tr>
<th>Carrying amount at 31 August 20X6</th>
<th>Carrying amount at 31 December 20X6</th>
<th>Reversal of impairment loss</th>
<th>Revised carrying amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Non-current assets</td>
<td>1,800</td>
<td>100</td>
<td>1,900</td>
</tr>
<tr>
<td>Current assets</td>
<td>340</td>
<td>–</td>
<td>325</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>(120)</td>
<td>–</td>
<td>(100)</td>
</tr>
<tr>
<td>Total</td>
<td>2,020</td>
<td>100</td>
<td>2,125</td>
</tr>
</tbody>
</table>
(a) The carrying amount of the disposal group at 31 December 20X6 is $2,025,000 (after remeasuring the current assets and liabilities outside the scope of SFRS(I) 5 in accordance with relevant standards).

(b) The fair value less costs to sell is $2.2 million

(c) The maximum impairment reversal is the lower of:
   (i) The initial impairment of $500,000
   (ii) The $175,000 by which the fair value less costs to sell exceeds carrying amount.

(d) Therefore the maximum impairment reversal is $175,000, however no reversal may be recognised in respect of goodwill. Therefore $100,000 is recognised in respect of non-current assets.

3.3 Reclassification of assets held for sale or distribution

Specific guidance in SFRS(I) 5 addresses the situation where an asset (or disposal group) classified as held for sale becomes held for distribution or vice versa.

In this situation, the change in classification is considered to be a continuation of the original plan of disposal and the original date of classification as held for sale/distribution is not changed. Therefore SFRS(I) 5’s classification, measurement and presentation requirements of the new method of disposal apply:

- If reclassified as held for sale the asset (or disposal group) is measured at the lower of carrying amount and fair value less costs to sell.
- If reclassified as held for distribution the asset (or disposal group) is measured at the lower of carrying amount and fair value less costs to distribute.
- Any reduction or increase in fair value less costs to sell (or distribute) are recognised as discussed above.

3.4 Measurement of an asset no longer held for sale or distribution

A non-current asset (or disposal group) that is no longer classified as held for sale (for example, because the sale has not taken place within one year) or no longer classified as held for distribution is measured at the lower of:

(a) Its carrying amount before it was classified as held for sale or as held for distribution to owners, adjusted for any depreciation, amortisation or revaluation that would have been recognised had the asset not been held for sale or held for distribution to owners, and

(b) Its recoverable amount at the date of the decision not to sell or distribute.

This treatment also applies to assets or disposal groups that cease to be classified as held for distribution.

SECTION SUMMARY

Non-current assets and disposal groups held for sale are measured at the lower of carrying amount and fair value less costs to sell. Non-current assets classified as held for sale are not depreciated.
4 Presentation of assets held for sale

SECTION INTRODUCTION

SFRS(I) 5 clarifies how non-current assets and disposal groups held for sale should be presented in the financial statements.

Non-current assets and disposal groups classified as held for sale should be presented separately from other assets in the statement of financial position. The liabilities of a disposal group should be presented separately from other liabilities in the statement of financial position.

(a) Assets and liabilities held for sale should not be offset.
(b) The major classes of assets and liabilities held for sale should be separately disclosed either in the statement of financial position or in the notes.

4.1 Additional disclosures

In the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold the following should be disclosed.

(a) A description of the non-current asset (or disposal group)
(b) A description of the facts and circumstances of the disposal
(c) Any gain or loss recognised when the item was classified as held for sale
(d) If applicable, the reportable segment in which the non-current asset (or disposal group) is presented in accordance with SFRS(I) 8 Operating Segments

Where an asset previously classified as held for sale is no longer held for sale, the entity should disclose a description of the facts and circumstances leading to the decision and its effect on the results for the period and any prior periods presented.

The required disclosures can be seen in the Fraser and Neave 2017 Annual Report. The balance sheet (statement of financial position) on page 97 includes the assets and liabilities of a disposal group held for sale and disclosure note 26 on page 143 provides further detail.


SECTION SUMMARY

Non-current assets held for sale and the assets and liabilities of a disposal group held for sale are presented separately from other assets and liabilities. Assets and liabilities associated with a disposal group held for sale are not offset. Additional details of the asset or disposal group are also required.
5 Discontinued operations

SECTION INTRODUCTION

SFRS(I) 5 defines a discontinued operation and requires its results to be presented separately in the financial statements.

SFRS(I) 5 provides a definition of a discontinued operation.

KEY TERMS

**DISCONTINUED OPERATION** A component of an entity that has either been disposed of, or is classified as held for sale, and:

(a) Represents a separate major line of business or geographical area of operations

(b) Is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations, or

(c) Is a subsidiary acquired exclusively with a view to resale.

**COMPONENT OF AN ENTITY** Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

An entity must present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets or disposal groups.

An entity should present a single amount in the statement of profit or loss and other comprehensive income comprising the total of:

(a) The post-tax profit or loss of discontinued operations; and

(b) The post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

An entity should also disclose an analysis of the above single amount into:

(a) The revenue, expenses and pre-tax profit or loss of discontinued operations

(b) The related income tax expense in relation to (a) above

(c) The gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or the discontinued operation

(d) The related income tax expense in relation to (c) above

This may be presented either in the statement of profit or loss and other comprehensive income or in the notes. If it is presented in the statement of profit or loss and other comprehensive income it should be presented in a section identified as relating to discontinued operations, ie separately from continuing operations. This analysis is not required where the discontinued operation is a newly acquired subsidiary that has been classified as held for sale on acquisition.

An entity should disclose the net cash flows attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either on the face of the statement of cash flows or in the notes.

Gains and losses on the re-measurement of a non-current asset or disposal group classified as held for sale that does not meet the definition of a discontinued operation should be included in profit or loss from continuing operations.
### 5.1 Illustration

The following illustration is from the Singapore Myanmar Investco Limited Annual Report 2017.

**CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME**

<table>
<thead>
<tr>
<th>The Group</th>
<th>2017</th>
<th>Restated 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year ended 31 March 2017</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>REVENUE</strong></td>
<td>5</td>
<td>US$'000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(18,469)</td>
<td>(US$6,295)</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td></td>
<td>US$'000</td>
</tr>
<tr>
<td>Other income</td>
<td>6</td>
<td>567</td>
</tr>
<tr>
<td>Distribution expenses</td>
<td>(1,235)</td>
<td>(US$1,010)</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>7</td>
<td>(US$7,450)</td>
</tr>
<tr>
<td>Finance costs</td>
<td>8</td>
<td>(US$915)</td>
</tr>
<tr>
<td>Other expenses</td>
<td>6</td>
<td>–</td>
</tr>
<tr>
<td>Share of results of joint ventures, net of tax</td>
<td></td>
<td>(US$71)</td>
</tr>
<tr>
<td><strong>Loss before tax from continuing operations</strong></td>
<td></td>
<td>(US$4,270)</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>10</td>
<td>(US$25)</td>
</tr>
<tr>
<td><strong>Loss from continuing operations net of tax</strong></td>
<td></td>
<td>(US$4,295)</td>
</tr>
<tr>
<td>Loss from discontinued operations, net of tax</td>
<td>11</td>
<td>(US$3,051)</td>
</tr>
<tr>
<td>Gain on disposal of discontinued operations</td>
<td>11</td>
<td>–</td>
</tr>
<tr>
<td><strong>Loss, net of tax</strong></td>
<td></td>
<td>(US$7,346)</td>
</tr>
</tbody>
</table>

**Other comprehensive income**

*Items that may be reclassified subsequently to profit or loss:*

- Exchange differences on translating foreign operations, – (US$160)
- **Other comprehensive income for the year, net of tax** – (US$160)
- **Total comprehensive loss for the year** (US$7,346) (US$665)

**Loss attributable to:**

- **Equity holders of the Company** (US$7,080) (US$319)
- Non-controlling interests, (US$266) (US$506)
- **Loss for the year** (US$7,346) (US$825)

**Total comprehensive loss attributable to:**

- **Equity holders of the Company** (US$7,080) (US$159)
- Non-controlling interests (US$266) (US$506)
- **(US$7,346) (US$665)**

**Earnings per share for loss from continuing and discontinued operations attributable to equity holders of the Company**

<table>
<thead>
<tr>
<th>Basic earnings per share</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>From continuing operations</td>
<td>(US$1.95)</td>
</tr>
<tr>
<td>From discontinued operations</td>
<td>(US$1.40)</td>
</tr>
<tr>
<td><strong>(US$3.35)</strong></td>
<td><strong>(0.21)</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Diluted earnings per share</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>From continuing operations</td>
<td>(US$1.95)</td>
</tr>
<tr>
<td>From discontinued operations</td>
<td>(US$1.40)</td>
</tr>
<tr>
<td><strong>(US$3.35)</strong></td>
<td><strong>(0.21)</strong></td>
</tr>
</tbody>
</table>

5.1.1 Alternative presentation

An alternative to this presentation would be to analyse the profit from discontinued operations in a separate column in the statement of profit or loss and other comprehensive income. Further illustrations can be found in the Implementation Guidance to SFRS(I) 5.

Question 21.2

Treatment of closure

On 20 October 20X3 the directors of a parent company made a public announcement of plans to close a subsidiary's steel works. The closure means that the group will no longer carry out this type of operation, which until recently has represented about 10% of its total turnover. The works will be gradually shut down over a period of several months, with complete closure expected in July 20X4. At 31 December 20X3 output had been significantly reduced and some redundancies had already taken place. The cash flows, revenues and expenses relating to the steel works can be clearly distinguished from those of the subsidiary's other operations.

Required

How should the closure be treated in the financial statements for the year ended 31 December 20X3?

SECTION SUMMARY

In respect of discontinued operations, a single amount should be presented in the statement of profit or loss and other comprehensive income comprising the total of the post-tax profit or loss of discontinued operations and the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation. Further analysis of this single figure must also be disclosed.
Chapter Roundup

SFRS(I) 5 Non-Current Assets Held for Sale and Discontinued Operations

Non-current assets (disposal groups) held for sale or distribution

- Available for immediate sale or distribution in present condition
- Sale or distribution highly probable

Measure

- In accordance with applicable FRS prior to classification
- Lower of carrying amount and fair value less costs to sell/distribute on classification
- Recognise impairment loss
- No further depreciation
- Remeasure at end of reporting period

Disclose

- Separately as current assets/current liabilities without offsetting
- Disclose separate classes of assets/liabilities held for sale

Discontinued operations

Operation disposed of or held for sale and:
- Separate major business or geographical area
- Single co-ordinated plan
- Subsidiary acquired with view to resale

Disclose

- Single amount in SPLOCI:
  - Post tax profit or loss of discontinued operation
  - Post tax gain or loss on disposal/measurement to fair value less costs to sell
- Disclose further analysis of single amount in SPLOCI or notes
- Net cash operating, investing and financing cash flows
Quick Quiz

1. For a non-current asset to be held for sale, a buyer must already have been found. True or false?

2. An asset held for sale should be measured at the lower of……………………. and ………………….. (Fill in the blanks.)

3. What must be presented in the statement of profit or loss and other comprehensive income in respect of discontinued operations?
Answers to Quick Quiz

1. False. There must be an active programme to locate a buyer.
2. The lower of its carrying amount and fair value less costs to sell.
3. A single amount comprising the total of:
   (a) The post-tax profit or loss of discontinued operations, and
   (b) The post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

Answers to Questions

21.1 Held for sale

The factory will not be transferred until the backlog of orders is completed; this demonstrates that the factory is not available for immediate sale in its present condition. The factory cannot be classified as 'held for sale' at 31 December 20X3. It must be treated in the same way as other items of property, plant and equipment: it should continue to be depreciated and should not be separately disclosed.

21.2 Treatment of closure

Because the steel works is being closed, rather than sold, it cannot be classified as 'held for sale'. In addition, the steel works is not a discontinued operation. Although at 31 December 20X3 the group was firmly committed to the closure, this has not yet taken place and therefore the steel works must be included in continuing operations. Information about the planned closure could be disclosed in the notes to the financial statements.
SFRS(I) 1-34 applies when an entity prepares interim financial report, without mandating when an entity should prepare such a report. This chapter explains the requirements of the standard.
1 Introduction

SECTION INTRODUCTION

SFRS(I) 1-34 Interim Financial Reporting lays down the principles and guidelines for the preparation of interim financial reports.

SFRS(I) 1-34 recommends that entities should produce interim financial reports, and for entities that do publish such reports, it lays down principles and guidelines for their production. It does not, however mandate the preparation of interim reports.

In Singapore, listed companies with market capitalisation in excess of $75 million are required to file quarterly reports. Please note that other legal authority, such as Rule 705 (2) and (3) from the Singapore Exchange (SGX) Rulebooks prescribe stricter interim reporting requirements.

1.1 Definitions

The following definitions are used in SFRS(I) 1-34.

KEY TERMS

**INTERIM PERIOD** A financial reporting period shorter than a full financial year.

**INTERIM FINANCIAL REPORT** A financial report containing either a complete set of financial statements (as described in SFRS(I) 1-1 Presentation of Financial Statements) or a set of condensed financial statements (as described in this standard) for an interim period.

1.2 Scope

SFRS(I) 1-34 does not make the preparation of interim financial reports mandatory, taking the view that this is a matter for governments, securities regulators, stock exchanges or professional accountancy bodies to decide within each country. It is, however, strongly recommended to governments, etc, that
Interim financial reporting should be a requirement for companies whose equity or debt securities are publicly traded. While SFRS(I) 1-34 encourages interim reporting by publicly traded entities, SGX mandates that all publicly traded entities will provide interim reports. (See http://rulebook.sgx.com/en/display/display_main.html?rbid=3271&element_id=1)

**Interim Financial Reporting Requirements**

<table>
<thead>
<tr>
<th>Market Capitalisation below $75m ¹</th>
<th>SGX 705</th>
<th>SFRS(I) 1-34</th>
</tr>
</thead>
<tbody>
<tr>
<td>1H (within 45 days of period end)</td>
<td>}</td>
<td>}</td>
</tr>
<tr>
<td>At least 1H (within 60 days of period end)</td>
<td>}</td>
<td>}</td>
</tr>
<tr>
<td>Market Capitalisation equal to/above $75m ²</td>
<td>1Q, 2Q, 3Q (within 45 days of period end)</td>
<td>}</td>
</tr>
<tr>
<td>Effective date</td>
<td>Periods ending on or after 31 March 2003</td>
<td>Periods ending on or after 1 October 2001</td>
</tr>
</tbody>
</table>

**Illustrative example:**

- Entity publishes interim financial reports quarterly
- Entity's financial year ends on 31 December
- For the interim period ended 30 Sep 2015, the entity will present the following financial statements (condensed or complete) in its interim quarterly financial report:

  **Statement of Financial Position:**
  - At 30 Sep 2015
  - 31 Dec 2014

  **Statement of Comprehensive Income**
  - 3 months ending 30 Sep 2015
  - 30 Sep 2014
  - Year-to-date

  **Statement of Cash Flows**
  - 3 months ending 30 Sep 2015
  - 30 Sep 2014
  - Year-to-date

  **Statement of Changes in Equity**
  - 3 months ending 30 Sep 2015
  - 30 Sep 2014
  - Year-to-date

  **Earnings per Share**
  - Based on weighted average number of ordinary shares in issue for the 3 months ending 30 Sep 2015
  - 30 Sep 2014
  - On a fully diluted basis for the 3 months ending 30 Sep 2015

  **Net Asset Value per Share**
  - At 30 Sep 2015
  - 31 Dec 2014

  **Dividends per ordinary share**
  - 3 months ending 30 Sep 2015
  - Year-to-date

¹ An issuer whose market capitalisation does not exceed $75 million must announce its first half financial statements immediately after the figures are available, but in any event not later than 45 days after the relevant financial period.
An issuer must announce its financial statements for each of the first three quarters of its financial year immediately after the figures are available, but in any event not later than 45 days after the quarter end if:

(a) Its market capitalisation exceeded $75 million as at 31 March 2003;
(b) It was listed after 31 March 2003 and its market capitalisation exceeded $75 million at the time of listing (based on the initial public offering issue price); or
(c) Its market capitalisation is $75 million or higher on the last trading day of each calendar year, commencing from 31 December 2006. An issuer who falls within this category for the first time, will have an initial grace period of one year to prepare to meet the requirements in Rule 705(2).

Therefore, a company with a year ending 31 December would be required as a minimum to prepare an interim report for the half year to 30 June and this report should be available before the end of August.

SECTION SUMMARY

SFRS(I) 1-34 recommends but does not mandate the preparation of interim reports (including their timing thereof). Where they are produced SFRS(I) 1-34 provides the principles and guidelines which should be applied in their preparation.

2 Form and content of an interim report

SECTION INTRODUCTION

SFRS(I) 1-34 specifies the minimum contents of an interim financial report.

SFRS(I) 1-34 specifies the **minimum component elements** of an interim financial report.

- Condensed statement of financial position
- Condensed statement of profit or loss and other comprehensive income
- Condensed statement of changes in equity
- Condensed statement of cash flows
- Selected note disclosures

The rationale for requiring only condensed statements and selected note disclosures is that entities need not duplicate information in their interim report that is contained in their full annual report for the previous financial year. Interim financial statements should **focus more on new events, activities and circumstances** as it is intended to provide an update on the latest complete set of annual financial statements.

Where **full financial statements** are given as interim financial statements, SFRS(I) 1-1 should be used as a guide, otherwise SFRS(I) 1-34 specifies minimum contents. Additional line items or notes shall be included if their omission would make the condensed interim financial statements misleading.

The **condensed statement of financial position** should include, as a minimum, each of the major components of assets, liabilities and equity as were in the statement of financial position at the end of the previous financial year, thus providing a summary of the economic resources of the entity and its financial structure.

The **condensed statement of profit or loss and other comprehensive income** should include, as a minimum, each of the component items of income and expense as are shown in profit or loss for the previous financial year, together with the earnings per share and diluted earnings per share.
The **condensed statement of changes in equity** should include, as a minimum, each of the major components of equity as were contained in the statement of changes in equity for the previous financial year of the entity.

The **condensed statement of cash flows** should show, as a minimum, the three major sub-totals of cash flow as required in statements of cash flows by SFRS(I) 1-7, namely: cash flows from operating activities, cash flows from investing activities and cash flows from financing activities.

### 2.1 Significant events and transactions

SFRS(I) 1-34 requires that an entity includes in its interim report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the last annual reporting period. Information disclosed in relation to those events should update the information presented in the most recent annual report.

**Question 22.1**

Give examples of events and transactions for which disclosures would be required if they were significant.

### 2.2 Additional disclosures

In addition to significant events, the notes to interim financial statements should include the following (unless the information is contained elsewhere in the interim financial report).

(a) A statement that the **same accounting policies and methods of computation** have been used for the interim financial statements as were used for the most recent annual financial statements. If not, the nature of the differences and their effect should be described. (The accounting policies for preparing the interim financial statements should only differ from those used for the previous annual accounts in a situation where there has been a change in accounting policy since the end of the previous financial year, and the new policy will be applied for the annual accounts of the current financial period.)

(b) Explanatory comments on the **seasonality or ‘cyclicality’** of operations in the interim period. For example, if a company earns most of its annual profits in the first half of the year, because sales are much higher in the first six months, the interim report for the first half of the year should explain this fact.

(c) The **nature and amount** of items during the interim period affecting assets, liabilities, capital, net income or cash flows, that are unusual, due to their nature, incidence or size

(d) The **issue, repayment or repurchase** of equity or debt securities

(e) Nature and amount of any **changes in estimates** of amounts reported in an earlier interim report during the financial year, or in prior financial years if these affect the current interim period

(f) **Dividends paid** on ordinary shares and the dividends paid on other shares

(g) **Segmental results** for the business segments or geographical segments of the entity (if required under SFRS(I) 8)

(h) Any **significant subsequent events since the end of the interim period**

(i) Effect of the acquisition or disposal of subsidiaries during the interim period

(j) Disclosures about fair value required of financial instruments in accordance with SFRS(I) 7 and SFRS(I) 13

(k) Disclosures required by SFRS(I) 12 for entities becoming or ceasing to be investment entities.
These disclosures must be given either in the interim financial statements or incorporated by cross-reference from the interim financial statements to some other statement (e.g., management commentary). The other statement must be available to users of the financial statements on the same terms as the interim statements and at the same time.

The entity should also disclose the fact that the interim report has been produced in compliance with SFRS(I) 1-34 on interim financial reporting.

2.3 Periods covered

The standard requires that interim financial reports should provide financial information for the following periods or as at the following dates:

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>Current period</th>
<th>Comparative</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>As at end of current period</td>
<td>As at end of most recent financial year</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of profit or loss and other comprehensive income</th>
<th>Current period</th>
<th>Comparative</th>
</tr>
</thead>
<tbody>
<tr>
<td>For current interim period</td>
<td>For corresponding interim period</td>
<td></td>
</tr>
<tr>
<td>For current period to date (cumulative basis)</td>
<td>For corresponding interim period (cumulative basis)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of cash flows</th>
<th>Current period</th>
<th>Comparative</th>
</tr>
</thead>
<tbody>
<tr>
<td>For current period to date (cumulative basis)</td>
<td>For corresponding interim period (cumulative basis)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of changes in equity</th>
<th>Current period</th>
<th>Comparative</th>
</tr>
</thead>
<tbody>
<tr>
<td>For current period to date (cumulative basis)</td>
<td>For corresponding interim period (cumulative basis)</td>
<td></td>
</tr>
</tbody>
</table>

You should review SFRS(I) 1-34 IE (A2).

Note that the SGX Rulebook extends this requirement (see section 1.2).

SECTION SUMMARY

Interim financial reports should include as a minimum condensed versions of the statements of financial position, profit or loss and other comprehensive income, changes in equity and cash flows. Disclosure should also be made of significant events and transactions since the last reporting date.

3 Recognition and measurement principles

SECTION INTRODUCTION

SFRS(I) 1-34 provides guidelines as to the practical application of the recognition and measurement principles.

A large part of SFRS(I) 1-34 deals with recognition and measurement principles, and guidelines as to their practical application. The guiding principle is that an entity should use the same recognition and measurement principles in its interim statements as it does in its annual financial statements. However, the frequency of an entity’s reporting should not affect the measurement of its annual results. To achieve this, measurements are to be made on a year-to-date basis.
This means, for example, that a cost that would not be regarded as an asset in the year-end statement of financial position should not be regarded as an asset in the statement of financial position for an interim period. Similarly, an accrual for an item of income or expense for a transaction that has not yet occurred (or a deferral of an item of income or expense for a transaction that has already occurred) is inappropriate for interim reporting, just as it is for year-end reporting.

Applying this principle of recognition and measurement may result, in a subsequent interim period or at the year-end, in a re-measurement of amounts that were reported in a financial statement for a previous interim period. The nature and amount of any significant re-measurements should be disclosed.

3.1 Revenues received occasionally, seasonally or cyclically

Revenue that is received as an occasional item, or within a seasonal or cyclical pattern, should not be anticipated or deferred in interim financial statements, if it would be inappropriate to anticipate or defer the revenue for the annual financial statements. In other words, the principles of revenue recognition should be applied consistently to the interim reports and year-end reports.

3.2 Costs incurred unevenly during the financial year

These should only be anticipated or deferred (ie treated as accruals or prepayments) if it would be appropriate to anticipate or defer the expense in the annual financial statements. For example, it would be appropriate to anticipate a cost for property rental where the rental is paid in arrears, but it would be inappropriate to anticipate part of the cost of a major advertising campaign later in the year, for which no expenses have yet been incurred.

The standard deals with specific applications of the recognition and measurement principle in SFRS(I) 1-34 Illustrative Examples. Some of these examples are set out below, by way of explanation and illustration.

3.2.1 Payroll taxes or insurance contributions paid by employers

In some countries these are assessed on an annual basis, but paid at an uneven rate during the course of the year, with a large proportion of the taxes being paid in the early part of the year, and a much smaller proportion paid later on in the year. In this situation, it would be appropriate to use an estimated average annual tax rate for the year in an interim statement, not the actual tax paid. This treatment is appropriate because it reflects the fact that the taxes are assessed on an annual basis, even though the payment pattern is uneven.

3.2.2 Cost of a planned major periodic maintenance or overhaul

The cost of such an event later in the year must not be anticipated in an interim financial statement unless there is a legal or constructive obligation to carry out this work. The fact that a maintenance or overhaul is planned and is carried out annually is not of itself sufficient to justify anticipating the cost in an interim financial report.

3.2.3 Other planned but irregularly-occurring costs

Similarly, these costs such as charitable donations or employee training costs, should not be accrued in an interim report. These costs, even if they occur regularly and are planned, are nevertheless discretionary.

3.2.4 Year-end bonus

A year-end bonus should not be provided for in an interim financial statement unless there is a constructive obligation to pay a year-end bonus (eg a contractual obligation, or a regular past practice) and the size of the bonus can be reliably measured. Where a company has a contractual obligation to pay an annual wage supplement (AWS) or 13th month pay at the end of the financial year, this is actually a
deferred wage or salary and should be accrued in an interim financial statement together with the applicable cost of the company’s contribution to the Central Provident Fund (CPF).

3.2.5 Holiday pay
The same principle applies here. If holiday pay is an enforceable obligation on the employer, then any unpaid holiday pay as a result of unused entitlement accumulated at the end of the reporting period may be accrued in the interim financial report. The accrued cost of holiday pay should include the cost of employer CPF contributions.

3.2.6 Intangible assets
The entity might incur expenses during an interim period on items that might or will generate non-monetary intangible assets. SFRS(I) 1-38 Intangible Assets requires that costs to generate non-monetary intangible assets (eg development expenditure) should be recognised as an expense when incurred unless the costs form part of an identifiable intangible asset. Costs that were initially recognised as an expense cannot subsequently be treated instead as part of the cost of an intangible asset. SFRS(I) 1-34 states that interim financial statements should adopt the same approach. This means that it would be inappropriate in an interim financial statement to ‘defer’ a cost in the expectation that it will eventually be part of a non-monetary intangible asset that has not yet been recognised: such costs should be treated as an expense in the interim statement.

3.2.7 Depreciation and amortisation
Depreciation and amortisation should only be charged in an interim statement on non-current assets that are currently held ready for use, not on non-current assets that will be acquired later in the financial year.

3.2.8 Foreign currency translation gains and losses
These should be calculated by the same principles as at the financial year-end, in accordance with SFRS(I) 1-21 The Effects of Changes in Foreign Exchange Rates.

3.2.9 Tax on income
An entity will include an expense for income tax (tax on profits) in its interim statements. The tax rate to use should be the estimated average annual tax rate for the year. For example, suppose that in a particular jurisdiction, the rate of tax on company profits is 17% on the first $200,000 of profit and 40% on profits above $200,000. Now suppose that a company makes a profit of $200,000 in its first half year, and expects to make $200,000 in the second half year. The rate of tax to be applied in the interim financial report should be 28.5%, not 17%, ie the expected average rate of tax for the year as a whole. This approach is appropriate because income tax on company profits is charged on an annual basis, and an effective annual rate should therefore be applied to each interim period.

As another illustration, suppose a company earns pre-tax income in the first quarter of the year of $30,000, but expects to make a loss of $10,000 in each of the next three quarters, so that net income before tax for the year is zero. Suppose also that the rate of tax is 17%. In this case, it would be inappropriate to anticipate the losses, and the tax charge should be $5,100 for the first quarter of the year (17% of $30,000) and a negative tax charge of $1,700 for each of the next three quarters, if actual losses are the same as anticipated.

Where the tax year for a company does not coincide with its financial year, a separate weighted average estimated effective tax rate should be applied for each tax year, to the interim periods that fall within that tax year.

Some countries give entities tax credits against the tax payable, based on amounts of capital expenditure or research and development, and so on. Under most tax regimes, these credits are calculated and granted on an annual basis; therefore it is appropriate to include anticipated tax credits within the calculation of the estimated annual effective income tax rate for the year, and apply this rate to calculate
the tax on income for interim periods. However, if a tax benefit relates to a specific one-time event, it should be recognised within the tax expense for the interim period in which the event occurs.

Examples of tax credits in Singapore are the Productivity and Innovation Credit scheme (see www.iras.gov.sg/irashome/Schemes/Businesses/Productivity-and-Innovation-Credit-Scheme/) and the Wage Credit Scheme (see www.iras.gov.sg/irashome/WCS.aspx)

3.2.10 Inventory costing and valuations

Within interim reports, inventories should be measured in the same way as for year-end accounts. It is recognised, however, that it will be necessary to rely more heavily on estimates for interim reporting than for year-end reporting.

In addition, it will normally be the case that the net realisable value of inventories should be estimated from selling prices and related costs to complete and dispose at interim dates.

Example

Z Ltd has a contractual agreement with employees that it will pay them a bonus each year of 10% of their salary if sales exceed 10 million units. During the first six months of the year Z Ltd sold 5.3 million units, which is in line with budgeted annual sales of 10.5 million. Annual salaries are estimated to be $60 million, with salary costs in the first half of the year being $27 million.

How should the bonus be reflected in the interim financial statements?

Solution

It is probable that the bonus will be paid, given that the actual output already achieved in the year is in line with budgeted figures, which exceed the required level of output. So a bonus of $2.7 million (10% × $27m) should be recognised in the interim financial statements.

Example

Woodlands Gifts Pte Ltd reports a profit before tax for the six months ended 31 July 20X3 of $100,000. As the business is seasonal, the profit before tax for the 12 months ended 31 January 20X4 is expected to amount to $300,000. Corporate income tax is levied at a flat rate of 17% regardless of the amount of profit reported.

Assuming that profit before tax is equal to taxable profits, what should the taxation charge be for the six months ended 31 July 20X3?

Solution

- The taxation charge in the interim financial statements is based upon the weighted average tax rate for the year.
- Woodlands Gifts Pte Ltd's tax rate for the year is expected to be 17%. The taxation charge in the interim financial statements will be $100,000 × 17% = $17,000.
Question 22.2

Lucky Foods Ltd is preparing interim statements for the quarter ended 31 March 20X3. At that date it has 100,000 units in stock, each of which cost $50. The net realisable value of each unit at 31 March 20X3 is $42, however the price of Lucky Foods' products is variable and the expected net realisable value at the year-end of 30 June 20X3 is $61.

How are the units of inventory measured in the financial statements?

3.3 Use of estimates

Although accounting information must be reliable and free from material error, it may be necessary to sacrifice some accuracy and reliability for the sake of timeliness and cost-benefits. This is particularly the case with interim financial reporting, where there will be much less time to produce reports than at the financial year-end. The standard therefore recognises that estimates will have to be used to a greater extent in interim reporting, to assess values or even some costs, than in year-end reporting.

SFRS(I) 1-34 Illustrative Examples gives some examples of the use of estimates.

(a) **Inventories.** An entity might not need to carry out a full inventory count at the end of each interim period. Instead, it may be sufficient to estimate inventory values using sales margins.

(b) **Provisions.** An entity might employ outside experts or consultants to advise on the appropriate amount of a provision, as at the year-end. It will probably be too costly and time-consuming to employ an expert to make a similar assessment at each interim date.

(c) **Revaluations.** An entity might employ a professional valuer to revalue non-current assets at the year-end, whereas at the interim date(s) the entity will not rely on such experts.

(d) **Income taxes.** The rate of income tax (tax on profits) will be calculated at the year-end by applying the tax rate in each country/jurisdiction to the profits earned there. At the interim stage, it may be sufficient to estimate the rate of income tax by applying the same 'blended' estimated weighted average tax rate to the income earned in all countries/jurisdictions.

The principle of **materiality** applies to interim financial reporting, as it does to year-end reporting. In assessing materiality, it needs to be recognised that interim financial reports will rely more heavily on estimates than year-end reports. Materiality should be assessed in relation to the interim financial statements themselves, and should be independent of 'annual materiality' considerations.

3.4 SFRS(I) INT 10 Interim Financial Reporting and Impairment

SFRS(I) INT 10 *Interim Financial Reporting and Impairment* addresses the issue of whether an entity should 'reverse impairment losses in an interim period on goodwill and investments in equity instruments and in financial assets carried at cost, if a loss would not have been recognised, or a smaller loss would have been recognised had an impairment assessment been made only at the end of a subsequent reporting period' (paragraph 7).

The consensus it reaches is that impairment losses in these circumstances should not be reversed.

**SECTION SUMMARY**

An entity should use the same recognition and measurement principles in its interim statements as it does in its annual financial statements. The standard provides a number of examples of the practical application of these principles. Estimates are used to a greater extent in interim reporting than in annual reporting.
Chapter Roundup

**SFRS(I) 1-34 Interim Financial Reporting**

- Principles and guidelines for production of interim statements
- Doesn't mandate which entities should produce interim statements
- SGX Rulebooks prescribe stricter requirements

**Minimum elements**

- Condensed statement of financial position
- Condensed statement of profit or loss and other comprehensive income
- Condensed statement of changes in equity
- Condensed statement of cash flows
- Selected note disclosures

**Recognition and measurement**

- Same basis as annual financial statements

- Seasonal revenue not anticipated or deferred
- Unevenly incurred costs not anticipated or deferred unless appropriate
- Estimates used to greater extent than in year-end reporting

**Significant events and transactions since last annual reporting period**

**Additional disclosures** (can be cross referenced to other reports available at the same time):
- Segmental results
- Subsequent events
- Acquisition/disposal of subsidiaries
- Fair value of financial instruments
- Investment entities
- Accounting policies
- Seasonality/cyclicality
- Unusual items
- Equity/debt issue/repayment
- Changes in estimates
- Dividends paid
Quick Quiz

1. Which companies are required to prepare an interim report in accordance with SFRS(I) 1-34?
2. What are the minimum contents of a statement of profit or loss and other comprehensive income in the interim statements?
3. What disclosure is required in respect of accounting policies in the interim statements?
4. How is a year-end bonus dealt with in the interim statements?
Answers to Quick Quiz

1. SFRS(I) 1-34 (paragraph 15B) does not require that any companies prepare interim reports, although it recommends that publicly traded companies do.

2. The condensed statement of profit or loss and other comprehensive income should include, as a minimum, each of the component items of income and expense as are shown in profit or loss for the previous financial year, together with the earnings per share and diluted earnings per share.

3. A statement that the same accounting policies and methods of computation have been used for the interim statements as were used for the most recent annual financial statements. If not, the nature of the differences and their effect should be described.

4. A year-end bonus should not be provided for in an interim financial statement unless there is a constructive obligation to pay a year-end bonus (e.g., a contractual obligation, or a regular past practice) and the size of the bonus can be reliably measured.

Answers to Questions

22.1 Disclosures

The following are examples taken from SFRS(I) 1-34:

(a) Write-down of inventories to net realisable value and the reversal of such a write-down

(b) Recognition of a loss from the impairment of property, plant and equipment, intangible assets, or other assets, and the reversal of such an impairment loss

(c) Reversal of any provisions for the costs of restructuring

(d) Acquisitions and disposals of items of property, plant and equipment

(e) Commitments for the purchase of property, plant and equipment

(f) Litigation settlements

(g) Corrections of fundamental errors in previously reported financial data

(h) Any debt default or any breach of a debt covenant that has not been corrected on or before the balance sheet date

(i) Related party transactions

(j) Changes in the classification of financial assets as a result of a change in the purpose or use of those assets

(k) Changes in contingent liabilities or contingent assets

22.2 Inventory Measurement

The basic principle of measuring inventory at the lower of cost and net realisable value is applied at the date of the quarter end. Therefore the units of inventory are measured at $42 each:

$42 \times 100,000 = $4.2$ million
You should be aware that smaller entities may have different accounting needs from larger entities, but SFRS(I) are generally designed for larger ones. This chapter considers the SFRS for Small Entities and the differences between this and SFRS(I).
1 Background

SECTION INTRODUCTION

SFRS(I) are principally designed for larger entities or entities with public accountability such as those quoted on the Singapore Exchange. However, in Singapore most entities are small.

In most countries the majority of companies or other types of business entity are very small. They are generally owned and managed by one person or a family. The owners have invested their own money in the business and there are no outside shareholders to protect (see section 2 for a discussion of the characteristics of small entities in Singapore).

Large entities, by contrast, particularly companies listed on a stock exchange such as the SGX, may have shareholders who have invested their money, to achieve capital growth and/or for an income stream, with no knowledge whatever of the company. These shareholders need protection and the regulations for such companies need to be more stringent.

It could therefore be argued that two separate financial reporting frameworks should be developed:

(a) A simplified framework for small companies with fewer regulations and disclosure requirements
(b) A comprehensive framework for larger companies with extensive and detailed requirements

1.1 Possible solutions

There are two approaches to overcoming the information-needs asymmetry:

<table>
<thead>
<tr>
<th>Differential reporting</th>
<th>Exemptions from full SFRS(I)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced standards specifically for smaller entities</td>
<td>Existing standards applied by smaller companies but with exemptions</td>
</tr>
</tbody>
</table>
These approaches are discussed in more detail as follows.

1.1.1 Differential reporting

A one-size-fits-all framework does not generate relevant and useful information, even if this information is reliable:

(a) The costs may not be justified for the more limited needs of users of small company financial statements.

(b) The purpose of the financial statements for smaller entities and the use to which they are put will not be the same as for listed companies.

Differential reporting overcomes this by tailoring the reporting requirements to the entity having regard to its degree of accountability and size, amongst others. The main characteristic that distinguishes small companies from other entities is the degree of public accountability. For example, a listed company or a public company, or a company such as a bank, which holds assets in a fiduciary capacity might be regarded as publicly accountable. Despite the label ‘small entity’, size is not the only criterion.

Differential reporting may have drawbacks in terms of reducing comparability between small and larger company accounts. Furthermore, problems may arise where entities no longer meet the criteria to be classified as small. However, differential reporting has been implemented by the Singapore ASC.

1.1.2 Exemptions from full financial reporting standards

Some financial reporting standards do not have any bearing on small company accounts; for example, a company with equity not quoted on a stock exchange is not required to comply with SFRS(I) 1-33 Earnings per Share. Also an entity with a small local market may find SFRS(I) 8 Operating Segments to be superfluous.

Other standards almost always have an impact. In particular, most small companies will be affected by standards on:

- Property, plant and equipment (SFRS(I) 1-16)
- Inventories (SFRS(I) 1-2)
- Events after the reporting period (SFRS(I) 1-10)
- Income taxes (SFRS(I) 1-12)
- Provisions, contingent liabilities and contingent assets (SFRS(I) 1-37)

An alternative approach to the issue of small company reporting is to reduce the exposure of small companies to SFRS(I)s on a standard-by-standard basis. For those ‘core’ standards listed above, small companies would be required to follow all or most of their provisions. For more complicated standards, small companies would have very brief general obligations.

Another point to note is that SFRS(I)s apply to material items. In the case of smaller entities, the amount that is material may be very small in monetary terms. However, the effect of not reporting that item may be material in that it would mislead users of the financial statements. A case in point is SFRS(I) 1-24 Related Party Disclosures. Smaller entities may well rely on trade with relatives of the directors/shareholders and this information needs to be disclosed.

1.2 The solution in Singapore

The Singapore ASC, like the IASB, has elected to use the differential reporting option as the solution to the issue of small company reporting. The IASB issued the IFRS for Small and Medium-Sized Entities (IFRS for SMEs) in 2009 and the ASC based their SFRS for Small Entities on this. The standards are essentially identical however the SFRS for Small Entities, unlike the IFRS for SMEs, contains quantitative criteria that an entity must achieve in order to use the standard.
SECTION SUMMARY

Small companies have different reporting needs from those of larger, particularly listed, companies. There are two possible approaches to the issue of small company reporting: differential reporting or exemptions from full financial reporting standards. The Singapore ASC has opted for the differential reporting solution and issued the SFRS for Small Entities based on the IFRS for SMEs.

2 Singapore Financial Reporting Standard for Small Entities

SECTION INTRODUCTION

The SFRS for Small Entities was published in December 2010 to meet the reporting requirements of small companies in Singapore. It underwent its first review after two years’ use, resulting in amendments in 2015.

The SFRS for Small Entities (SFRS for SEs) was published in December 2010. It is shorter than the volume of full SFRS(I)s, and has simplifications that reflect the needs of users of small entities’ financial statements and cost-benefit considerations. It is designed to facilitate financial reporting by small entities in a number of ways:

(a) SFRS for SEs provides concise guidance in relation to presentation and disclosure.

(b) Many of the principles for recognising and measuring assets, liabilities, income and expenses in full SFRS(I)s are simplified.

(c) Where full SFRS(I)s allow accounting policy choices, the SFRS for SEs allows only the easier option.

(d) Topics not relevant to small entities are omitted.

(e) Significantly fewer disclosures are required.

(f) The standard has been written in clear language that can easily be translated.

The SFRS for SEs is a standalone standard, and with the exception of an option to use the recognition and measurement requirements of FRS 39 (equivalent to SFRS(I) 1-39) in combination with the disclosure requirements of the SFRS for SEs, there is no option to ‘mix and match’ the standard with full standards.

Note that although the ‘fallback’ option described above means that a small entity may apply the recognition and measurement requirements of FRS 39, there is no similar option to apply the requirements of FRS 109 (equivalent to SFRS(I) 9). Small entities applying the SFRS for SEs may not apply FRS 109. Therefore this option is only available for accounting periods beginning before 1 January 2018, when FRS 39 is withdrawn.

2.1 Initial comprehensive review

The IASB undertook an initial comprehensive review of the IFRS for SMEs after two full years of use. As a result, it issued amendments to the standard in May 2015; these were issued as amendments to the SFRS for Small Entities in November 2015. The amendments:

- Reflect changes made to full standards since the issue of the SFRS for SEs
• Introduce a number of new ‘undue cost and effort’ exemptions which can be used to exempt small entities from applying certain requirements of the standard where to do so would result in undue cost or effort

• Introduce a requirement to disclose instances when the undue cost or effort exemption has been used

The amendments are reflected in the text of the chapter and are effective for annual periods beginning on or after 1 January 2017.

2.2 Eligibility to use the SFRS for Small Entities

The SFRS for SEs is an alternative framework to full standards for eligible entities in Singapore. Eligible entities can choose to apply full standards or the SFRS for SEs. An entity is eligible to apply the SFRS for SEs if:

Qualitative Criteria

• It is not publicly accountable

• It publishes general purpose financial statements for external users

An entity is publicly accountable if:

(a) Its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (such as a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(b) It is a deposit-taking entity and/or holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. Most banks, insurance companies, securities brokers/dealers, mutual funds and investment banks meet this criteria;

(c) It is a public company defined under the Singapore Companies Act (Cap 50); or

(d) It is a charity defined under the Charities Act (Cap 37).

Quantitative Criteria

• It satisfies at least two of the following three criteria:

  (a) Total annual revenue of not more than S$10m

  (b) Total assets of not more than S$10m

  (c) Total number of employees of not more than 50 at the end of the reporting period

The qualitative criteria must be satisfied in the year of initial application of the SFRS for SEs and the quantitative criteria must be satisfied for the previous two consecutive reporting periods. In the case of a newly incorporated entity, only the qualitative criteria apply in the first two reporting periods.

For subsequent application the entity must continue to meet the qualitative criteria in the year of application and must not have fallen out of the quantitative criteria for the previous two consecutive reporting periods.

The 2015 amendments made to the SFRS for SEs clarify that a parent entity should assess its eligibility to use the standard in its separate financial statements on the basis of its own status without considering whether other group entities, or the group as a whole, has public accountability.
Example

Entities A, B and C are not publicly accountable and publish general-purpose financial statements for external users.

The following table indicates in which years each entity meets the quantitative criteria required to apply the *SFRS for SEs*:

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
<th>20X5</th>
<th>20X6</th>
<th>20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity A</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Entity B</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Entity C</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

Can these entities apply the *SFRS for SEs* in the years 20X3–20X7 inclusive (assuming that the qualitative criteria are met throughout)?

Solution

<table>
<thead>
<tr>
<th></th>
<th>20X3</th>
<th>20X4</th>
<th>20X5</th>
<th>20X6</th>
<th>20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity A</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Entity B</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Entity C</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Entity A may apply the *SFRS for SEs* throughout the years 20X3 to 20X7 because:

(a) It meets the qualitative criteria throughout, and

(b) At no stage does it fall out of the quantitative criteria for the previous two consecutive reporting periods.

Entity B may apply the *SFRS for SEs* throughout the years 20X3 to 20X5 because

(a) It meets the qualitative criteria throughout, and

(b) At no stage does it fall out of the quantitative criteria for the previous two consecutive reporting periods.

As Entity B does not meet the quantitative criteria in the years 20X4 or 20X5, it is not eligible to report under the *SFRS for SEs* in 20X6 or 20X7 as the requirement to meet the quantitative criteria for the previous two consecutive reporting periods is not met.

Entity C does not meet the quantitative criteria until 20X3, therefore it cannot report under the *SFRS for SEs* until 20X5 ie after it has met the criteria for the two accounting periods prior to the current period. It may then report under the *SFRS for SEs* until it falls out of the quantitative criteria for the two consecutive periods prior to the reporting period.

2.3 Accounting policies

For situations where the *SFRS for SEs* does not provide specific guidance, it provides a hierarchy for determining a suitable accounting policy. A small entity must consider, in descending order:

(a) The guidance in the *SFRS for SEs* on similar and related issues.

(b) The definitions, recognition criteria and measurement concepts in Section 2 *Concepts and Pervasive Principles* of the standard.
The entity also has the option of considering the requirements and guidance in the full reporting standards dealing with similar topics. However, it is under no obligation to do this, or to consider the pronouncements of other standard setters.

2.4 Overlap with full SFRS(I)

In the following areas, the recognition and measurement guidance in the SFRS for SEs is similar to that in the full SFRS(I).

- Provisions and contingencies
- Hyperinflation accounting (not within the FR syllabus)
- Events after the end of the reporting period

2.5 Omitted topics

The SFRS for SEs does not address the following topics that are covered in full SFRS(I).

- Earnings per share
- Interim financial reporting
- Segment reporting
- Classification for non-current assets (or disposal groups) as held for sale and discontinued operations

2.6 Examples of options in full SFRS(I) not included in the SFRS for SEs

- Revaluation model for intangible assets
- Choice between cost and fair value models for investment property (measurement depends on the circumstances)

Although the SFRS for SEs as originally issued prohibited the use of the revaluation model for property, plant and equipment, the 2015 amendments to the standard introduced an accounting policy option to measure property, plant and equipment at a revalued amount.

2.7 Revenue and leases

Neither SFRS(I) 15 Revenue from Contracts with Customers nor SFRS(I) 16 Leases is reflected in the SFRS for SEs. This is because both were developed after the SFRS for SEs. In both cases guidance for small entities is based on old Singapore standards (FRS 11 Construction Contracts, FRS 17 Leases and FRS 18 Revenue).

In respect of accounting for revenue and leases, the most significant difference between full SFRS(I) and the SFRS for SEs arises in respect of lessee accounting for leases. Whilst SFRS(I) 16 requires that a single accounting model is applied to all leases with the exception of short-term leases and leases for low value assets, the SFRS for SEs requires that leases are classified as either an operating or finance lease at inception. Operating leases are recognised as an expense on a straight-line basis over the lease term (with no asset or liability recognised in the statement of financial position); finance lease accounting is similar to SFRS(I) 16 requirements in that an asset and liability are recognised in respect of a lease, however measurement requirements differ.

It is expected that the guidance on these topics within the SFRS for SEs will be updated at the next review of the standard in order to better reflect the requirements of full SFRS(I).
2.8 Principal recognition and measurement simplifications

(a) Financial instruments

Financial instruments meeting specified criteria are measured at cost or amortised cost. All others are measured at fair value through profit or loss, although the 2015 amendments introduce an undue cost or effort exemption regarding the requirement to measure investments in equity instruments at fair value. The procedure for derecognition has been simplified, and hedge accounting is permitted only if certain requirements are met.

(b) Intangible assets other than goodwill

These are always amortised over their estimated useful life. If useful life can't be established reliably, useful life is determined based on management's best estimate (which must not exceed ten years).

(c) Investments in associates and joint ventures

These can be measured at cost, but fair value must be used if there is a published price quotation.

(d) Research and development costs and borrowing costs

must be expensed.

(e) Property, plant and equipment and intangibles

There is no need to review residual value, useful life and depreciation method unless there is an indication that they have changed since the most recent reporting date.

(f) Income tax

The 2015 amendments align the main principles of the SFRS for SEs with SFRS(I) 1-12 Income Taxes for the recognition and measurement of deferred tax, however these are modified to be consistent with the other requirements of the SFRS for SEs. In addition an undue cost or effort exemption from the requirement to offset income tax assets and liabilities is introduced. Guidance on income taxes included in the original SFRS for SEs was based on an exposure draft of amendments to IAS 12 (SFRS(I) 1-12) that was not finalised by the IASB.

(g) Held-for-sale assets

There is no separate held-for-sale classification; holding an asset or group of assets for sale is an indicator of impairment.

(h) Biological assets

SMEs are to use the cost less depreciation less impairment model unless the fair value is readily determinable, in which case the fair value through profit or loss model is required.

(i) Equity-settled share-based payment

If observable market prices are not available to measure the fair value of the equity-settled share-based payment, the directors' best estimate is used.

2.9 Presentation and disclosure simplifications

(a) Financial statement presentation

An entity may present a single statement of income and retained earnings in place of the statement of comprehensive income and statement of changes in equity where the only changes in equity arise from profit or loss, correction of errors, changes in accounting policy and the payment of dividends.
(b) **Third statement of financial position**

A third statement of financial position at the beginning of the comparative period is not required where a small entity makes a retrospective adjustment or reclassifies items in the financial statements.

(c) **Related party transactions**

Disclosure of key management personnel compensation is required in total only. Parent and subsidiary relationships must be disclosed regardless of whether there are any related party transactions.

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### SECTION SUMMARY

Published in 2010 and amended in 2015, the *SFRS for SEs* aims to simplify financial reporting for small companies by omitting irrelevant topics, reducing disclosure and eliminating choice. It simplifies some of the recognition and measurement principles as well as the presentation and disclosure requirements.

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### 3 Practical considerations

#### SECTION INTRODUCTION

There is **no perfect solution** to the information-needs asymmetry divide. There are advantages and disadvantages of the *SFRS for SEs*.

Since *SFRS for SEs* has been written using more simplified terms and is less onerous to apply than full FRS, differences arise on application, even where the principles are the same. Most of the exemptions in the *SFRS for SEs* are on the grounds of undue cost or effort. However, despite the practical advantages of a simpler reporting framework, there are costs involved for those moving to the *SFRS for SEs*.

#### 3.1 Advantages and disadvantages of the *SFRS for SEs*

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less time spent on FRS compliance so more time, money and resources are available to focus on business operations</td>
<td>It does <strong>not</strong> focus on the <strong>smallest companies</strong> although the International Accounting Standards Board has issued <em>A Guide for Micro-sized Entities: Applying the IFRS for SMEs</em> (2009) to assist smaller entities</td>
</tr>
<tr>
<td><em>SFRS for SEs</em> is <strong>structured according to topics</strong>, which should make it practical to use</td>
<td>The standard <strong>may be more onerous, particularly during any transition phase</strong> for <strong>smaller companies</strong>, with cost implications of adopting it</td>
</tr>
<tr>
<td>Reduced disclosure and regulatory requirements</td>
<td>There is a need to keep abreast of two sets of financial reporting standards (FRS and <em>SFRS for SEs</em>)</td>
</tr>
</tbody>
</table>
Advantages
Simplified accounting policy options, as well as simplified recognition and measurement principles removes some of the management decisions required

Disadvantages
Although SFRS for SEs provides a simplified financial reporting framework, having fewer accounting policy options may negatively affect loan covenants or financing options/terms

Further simplifications could be made (see section 3.1.1).
Small entities that are growing need to know when the entity qualifies or fails to qualify, and make adjustments accordingly
An entity that adopts SFRS for SEs may be perceived as lacking ambition to grow, which may restrict its opportunities
Reduced disclosure may make the financial statements harder to understand

3.1.1 Further simplifications
It has been argued that the SFRS for SEs would benefit from further simplifications. These might include:
(a) No requirement to value intangibles separately from goodwill on a business combination (although the 2015 amendments introduce an undue cost or effort exemption from doing so)
(b) No recognition of deferred tax
(c) No measurement rules for equity-settled share-based payment
(d) No requirement for consolidated accounts
(e) All leases accounted for by applying SFRS(I) 16 simplified accounting with enhanced disclosures
(f) Fair value measurement only when readily determinable without undue cost or effort

3.2 Transition to SFRS for SEs
Where an entity that previously applied full Singapore standards is eligible to use, and chooses to switch to, the SFRS for SEs, it must consider the transitional procedures given in the SFRS for SEs.

3.2.1 Date of transition statement of financial position
The date of transition is the beginning of the earliest period presented in a set of financial statements. Therefore a company that wishes to apply the SFRS for SEs with effect from 1 January 2019 has a date of transition of 1 January 2018 ie the start of the comparative period.

At the date of transition, a statement of financial position is prepared in which:
- Assets and liabilities are recognised if the SFRS for SEs requires it
- Assets and liabilities are not recognised if the SFRS for SEs does not permit it
- Items are reclassified in accordance with the requirements of the SFRS for SEs (if applicable)
- Assets and liabilities are measured in accordance with the SFRS for SEs

3.2.2 Accounting policies
Where accounting policies applied in the transition date statement of financial position differ from those applied previously, any necessary adjustments are recognised in equity (usually retained earnings) at the date of transition.
Certain accounting policies are not changed retrospectively:

- Financial assets and liabilities that have been derecognised under an entity's previous accounting standards but would not have been under the *SFRS for SEs* are not recognised on transition.

- Financial assets and liabilities that would have been derecognised under the *SFRS for SEs* but have not been derecognised under the previous accounting framework. These may be either derecognised on adoption of the *SFRS for SEs* or continue to be recognised until disposed of or settled.

- For hedge accounting relationships that no longer exist at the date of transition no adjustment is made.

- For hedge accounting relationships that still exist at the date of transition, the requirements of the *SFRS for SEs* are followed.

- Accounting estimates
- Discontinued operations
- The measurement of non-controlling interests.

The 2015 amendments to the standard add a further exception to retrospective application in respect of government loans. Therefore, if an entity received a government loan prior to transition, but did not recognise and measure it on a basis consistent with the *SFRS for SEs*, the previous carrying amount of the loan is retained as carrying amount at the date of transition and the benefit of a below market rate of interest is not recognised.

### 3.2.3 Exemptions

The following exemptions may be applied in preparing financial statements that conform to the *SFRS for SEs* for the first time:

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business combinations</td>
<td>The section of the <em>SFRS for SEs</em> on business combinations and goodwill need not be applied to business combinations that were effected before the date of transition.</td>
</tr>
<tr>
<td>Share-based payment transactions</td>
<td>The section of the <em>SFRS for SEs</em> on share-based payments need not be applied to equity instruments granted before the date of transition or share-based payment transaction liabilities that were settled before the date of transition.</td>
</tr>
<tr>
<td>Property, plant and equipment, investment property, intangible assets</td>
<td>Fair value may be used as deemed cost on the date of transition to the <em>SFRS for SEs</em>. Alternatively a revaluation amount under previous GAAP at or before the date of transition may be used as deemed cost.</td>
</tr>
<tr>
<td>Cumulative translation differences</td>
<td>Cumulative translation differences for all foreign operations may be deemed to be zero at the date of transition.</td>
</tr>
<tr>
<td>Separate financial statements</td>
<td>Where an investment in subsidiary, associate or joint venture is measured at cost under the <em>SFRS for SEs</em>, deemed cost at the date of transition may be fair value or the carrying amount under previous GAAP.</td>
</tr>
<tr>
<td>Compound financial instruments</td>
<td>A compound instrument need not be split into equity and liability elements if the liability element is not outstanding at the date of transition.</td>
</tr>
</tbody>
</table>
Deferred tax  | The requirements of the SFRS for SEs may be applied prospectively from the date of transition.

Arrangements containing a lease  | A first time adopter may elect to determine whether an arrangement contains a lease on the basis of facts and circumstances at the date of transition rather than when the arrangement was entered into.

Decommissioning liabilities in the carrying amount of PPE  | On adoption of the SFRS for SEs an entity may elect to measure a decommissioning liability at the date of transition rather than when the obligation arose.

3.2.4 Disclosure

An entity must explain how the transition from its previous financial reporting framework to the SFRS for SEs affected its financial position, performance and cash flows.

In order to achieve this, the first financial statements prepared under the SFRS for SEs should include:

(a) A description of the nature of each change in accounting policy

(b) Reconciliations of equity determined in accordance with previous financial reporting framework to equity determined in accordance with the SFRS for SEs for both of the following dates:
   (i) The date of transition to the SFRS for SEs, and
   (ii) The end of the latest period presented in the entity's most recent annual financial statements determined in accordance with its previous financial reporting framework.

(c) A reconciliation of the profit or loss determined in accordance with its previous financial reporting framework for the latest period in the entity's most recent annual financial statements to its profit or loss determined in accordance with the SFRS for SEs in the same period.

SECTION SUMMARY

The SFRS for SEs is an easy to read, accessible document which reduces financial reporting requirements for small entities. The standard does not, however, focus on the smallest companies and its adoption by an entity has cost implications. It is also argued that further simplifications to accounting requirements should be made.
Chapter Roundup

Small entities (SEs)

Differential reporting approach

SFRS for SEs

Entity must meet
- Qualitative criteria
- Quantitative criteria

IASB proposals to revise IFRS for SMEs

Standalone Standard

Reduced presentation and disclosure

Simplified recognition and measurement principles

Reduced accounting policy choices

Topics not relevant to SEs omitted

Topics not relevant to SEs omitted
Quick Quiz

1. What is differential financial reporting?

2. The treatment of provisions is simpler in the SFRS for Small Entities than in SFRS(I) 1-37. True or false?

3. The financial instruments categories ‘held-to-maturity’ and ‘available-for-sale’ are not included in the SFRS for Small Entities. True or false?

4. How are borrowing costs treated in the SFRS for SEs?

5. Give an example of an accounting choice in full SFRS(I) that is removed in the SFRS for SEs.
Answers to Quick Quiz

1. Producing new reduced standards specifically for smaller companies. In Singapore, the ASC has condensed the financial reporting requirements for small entities into a single document, *SFRS for Small Entities*.

2. False. Provisions are one area in which the recognition and measurement guidance in the *SFRS for Small Entities* is like that in the full SFRS(I).

3. True.

4. They are always expensed (para 25.2).

5. The choice to revalue intangible assets after initial recognition; the choice to measure investment property using either the fair value or cost model after initial recognition.
PART G
Consolidated Financial Statements
Basic groups were covered in your earlier studies. In this chapter, you will revise briefly the main principles of consolidation before moving on to trickier aspects of consolidation in the following chapters.

**Topic list**

1. Group accounts and levels of investment
2. SFRS(I) 10 Consolidated Financial Statements
3. SFRS(I) 3 Business Combinations
4. SFRS(I) 12 Disclosure of Interests in Other Entities
5. Current developments
## Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Group Accounting</strong></td>
<td></td>
</tr>
<tr>
<td>Identify and outline:</td>
<td></td>
</tr>
<tr>
<td>• The circumstances in which a group is required to prepare consolidated financial statements; and</td>
<td>3</td>
</tr>
<tr>
<td>• The circumstances when a group may claim an exemption from the preparation of consolidated financial statements.</td>
<td></td>
</tr>
<tr>
<td>Apply and discuss the criteria used to distinguish between a subsidiary and an associate.</td>
<td>3</td>
</tr>
<tr>
<td>Apply the principles in determining the fair value of consideration transferred.</td>
<td>3</td>
</tr>
<tr>
<td>Apply the recognition and measurement criteria for identifiable acquired assets and liabilities and goodwill including situations where business combinations are achieved in stages.</td>
<td>3</td>
</tr>
<tr>
<td><strong>Continuing and Discontinued Interests</strong></td>
<td>3</td>
</tr>
<tr>
<td>Apply and discuss the treatment of a subsidiary which has been acquired exclusively with a view for subsequent disposal.</td>
<td></td>
</tr>
<tr>
<td><strong>Emerging Trends</strong></td>
<td>1</td>
</tr>
<tr>
<td>Demonstrate awareness of both domestic and international current developments.</td>
<td></td>
</tr>
</tbody>
</table>

Statements of Cash Flows will be covered in Chapter 30.

## ESSENTIAL READING

SFRS(I) 1-27 *Separate Financial Statements*, SFRS(I) 1-28 *Investments in Associates and Joint Ventures*, SFRS(I) 3 *Business Combinations*, SFRS(I) 3 *Illustrative Examples* SFRS(I) 10 *Consolidated Financial Statements*, SFRS(I) 10 *Illustrative Examples* SFRS(I) 11 *Joint Arrangements*, SFRS(I) 11 *Illustrative Examples*, SFRS(I) 12 *Disclosure of Interests in Other Entities*, ED/2016/1 *Definition of a Business and Accounting for Previously Held Interests (amendments to IFRS 3 and IFRS 11)*

## 1 Group accounts and levels of investment

### SECTION INTRODUCTION

A group is regarded as a single economic entity for the purposes of financial reporting.
In traditional accounting terminology, a **group of companies** consists of a **parent company** and one or more **subsidiary companies** which are controlled by the parent company. In this situation, group accounts (or consolidated accounts) are prepared for the shareholders of the parent company, who also indirectly own any subsidiary entities.

### 1.1 Purpose of group accounts

Although each individual Singapore company within a group is legally bound (but can be exempted under certain circumstances) to prepare financial statements, having many sets of individual financial statements is not conducive to providing investors in the group with a full understanding of the performance and position of their investment.

This is particularly the case where high levels of intra group transactions take place, as these are often not measured at a market value and so distort the financial statements of the individual transacting companies. For example, a subsidiary company may sell goods to its parent company at below market price. This will result in deflated profits for the subsidiary and inflated profits for the parent company.

There is therefore a need for group financial statements which present the group as a single economic entity and remove the effect of any intragroup transactions, whilst reporting all transactions with unrelated third parties. Even market value transactions within the group will distort the overall view of the combined set of companies in the group unless they are removed. For example, sales between two group entities will overstate revenue and costs of sales unless removed.

These are the consolidated financial statements, and this is an example of commercial substance taking accounting precedence over legal form; a group has no legal status, however the position and performance of the group have more relevance to investors and other users of financial statements.

### 1.2 Levels of investments

Although the above discussion refers to a parent and subsidiary company, these are not the only companies which may be represented in consolidated financial statements. Do note, however that there must be at least one subsidiary in order for consolidated financial statements to be produced.

SFRS(I) 1-28 *Investments in Associates and Joint Ventures*, SFRS(I) 10 *Consolidated Financial Statements* and SFRS(I) 11 *Joint Arrangements* provide definitions of types of group company as follows:

**KEY TERMS**

A **Parent** is an entity that controls one or more entities. *(SFRS(I) 10 Appendix A)*

A **Subsidiary** is an entity that is controlled by another entity. *(SFRS(I) 10 Appendix A)*

An **Associate** is an entity over which the investor has significant influence. *(SFRS(I) 1-28 (3))*

A **Joint Arrangement** is an arrangement of which two or more parties have joint control. *(SFRS(I) 11 Appendix A)*

A **Joint Operation** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. *(SFRS(I) 11 Appendix A)*

A **Joint Venture** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. *(SFRS(I) 11 Appendix A)*

These definitions together with the meaning of ‘control’, ‘significant influence’ and ‘joint control’ are considered in more detail later in this chapter and later chapters. For the time being though, we shall concentrate on the types of investment and an overview of the accounting treatment of each.
1.3 Accounting treatment summary

Before moving onto the principles of consolidation, we can summarise the different types of investment and the likely* required accounting for them as follows.

<table>
<thead>
<tr>
<th>Investment</th>
<th>Criteria</th>
<th>Required treatment in group accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidiary</td>
<td>Control</td>
<td>Consolidation using acquisition method</td>
</tr>
<tr>
<td>Associate</td>
<td>Significant influence</td>
<td>Equity method</td>
</tr>
<tr>
<td>Joint arrangements</td>
<td>Contractual arrangement</td>
<td>Equity method or share of assets, liabilities, revenues and expenses**</td>
</tr>
<tr>
<td>Investment which is none of the above</td>
<td>Asset held for accretion of wealth</td>
<td>As for single company accounts per SFRS(I) 9</td>
</tr>
</tbody>
</table>

* There are a number of exceptions to the above and these are covered in the following sections and chapters.

** The treatment of joint arrangements including joint ventures is covered in more detail in Chapter 26.

The accounting treatment is prescribed by the following standards:

- SFRS(I) 1-27 Separate Financial Statements
- SFRS(I) 1-28 Investments in Associates and Joint Ventures
- SFRS(I) 3 Business Combinations
- SFRS(I) 10 Consolidated Financial Statements
- SFRS(I) 11 Joint Arrangements
- SFRS(I) 12 Disclosure of Interests in Other Entities

SESECTION SUMMARY

Consolidated financial statements are an example of substance over form; they are prepared in order to allow investors and other users to better understand the performance and position of a group of companies.

2 SFRS(I) 10 Consolidated Financial Statements

SECTION INTRODUCTION

SFRS(I) 10 Consolidated Financial Statements requires a parent to present consolidated financial statements.

SFRS(I) 10 provides guidance to establish a parent-subsidiary relationship and deals with the principles of consolidation and consolidation procedures.
2.1 Parent–subsidiary relationship

We have already said that a parent is an entity that controls one or more other entities and a subsidiary is an entity that is controlled by another entity. The definition of control is therefore key.

**KEY TERM**

An investor **CONTROLS** an investee when the investor is exposed, or has rights to, variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

(SFRS(I) 10 Appendix A)

There are therefore three elements to control:

(a) Power over the investee
(b) Exposure or rights to variable returns from involvement with the investee, and
(c) The ability to use the power to affect the amount of returns.

These elements must be assessed on a continual basis and if there are changes to one or more elements of control then an investor should reconsider whether it controls an investee.

2.1.1 Power

**Power** is defined as existing **rights that give the current ability to direct the relevant activities of the investee**. There is no requirement for that power to have been exercised.

Relevant activities may include (but are not limited to) the following:

- Selling and purchasing goods or services
- Managing financial assets
- Selecting, acquiring and disposing of assets
- Researching and developing new products and processes
- Determining a funding structure or obtaining funding

In some cases assessing power is straightforward, for example, where power is obtained directly and solely from having the majority of voting rights or potential voting rights, and as a result the ability to direct relevant activities.

In other cases, assessment is more complex and more than one factor must be considered. SFRS(I) 10 gives the following examples of substantive **rights**, other than voting or potential voting rights, which individually, or in combination, can give an investor de facto power.

- Rights to appoint, reassign or remove key management personnel who can direct the relevant activities
- Rights to appoint or remove another entity that directs the relevant activities
- Rights to direct the investee to enter into, or veto changes to transactions for the benefit of the investor
- Other rights, such as decision-making rights specified in a management contract that give the holder the ability to direct the relevant activities

SFRS(I) 10 suggests that the **ability** rather than contractual right to achieve the above may also indicate that an investor has power over an investee.

An investor can have power over an investee even where other entities have significant influence or other ability to participate in the direction of relevant activities. However, where an investor only has a protective rights (such as restricting the borrowing ability of the entity) they would not have power over the investee.
2.1.2 Returns

An investor must have exposure, or rights, to **variable returns** from its involvement with the investee in order to establish control.

This is the case where the investor's returns from its involvement are not fixed and have the potential to vary as a result of the investee's performance.

Returns may include:

(a) Dividends, other distributions of economic benefits from an investee (eg interest from debt securities issued by the investee) and changes in the value of the investor's investment in that investee

(b) Remuneration for servicing an investee's assets or liabilities

(c) Fees and exposure to loss from providing credit support

(d) Returns as a result of achieving synergies or economies of scale through an investor combining use of their assets with use of the investee's assets

2.1.3 Link between power and returns

In order to establish control, an investor must be able to use its power to affect its returns from its involvement with the investee. This is the case even where the investor delegates its decision making powers to an agent.

2.2 Principles of consolidation

2.2.1 Requirement to prepare consolidated financial statements

Where a parent controls one or more subsidiaries, SFRS(I) 10 requires that consolidated financial statements are prepared to include **all subsidiaries, both foreign and domestic** (subject to 2.2.2 and 2.2.3 below).

Historically management of some companies may have been tempted to manipulate their results by not consolidating all subsidiaries. If a subsidiary which carried a large amount of debt could be excluded, then the gearing of the group as a whole would be improved. In other words, this was a possible but inappropriate way of taking debt out of the consolidated statement of financial position. SFRS(I) 10 reduces the possibility of this type of manipulation as there are very few instances where SFRS(I) 10 allows a subsidiary to be excluded from consolidation.

2.2.2 Exemption from preparing group accounts

A parent need not present consolidated financial statements if and only if all of the following hold:

(a) The parent is itself a **wholly-owned subsidiary** or it is a **partially owned subsidiary** of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements.

(b) Its debt or equity instruments are **not publicly traded**.

(c) It is **not in the process of issuing securities** in public securities markets.

(d) The **ultimate or any intermediate parent** publishes consolidated financial statements that apply when an entity prepares separate financial statements in compliance with either Singapore Financial Reporting Standards (International) (SFRS(I)), with another reporting framework such as the International Financial Reporting Standards (IFRS), or with United States Generally Accepted Accounting Practices (US GAAP).

A parent that does not present consolidated financial statements must comply with SFRS(I) 1-27 (para 8) and present only separate financial statements (discussed later in this section).
2.2.3 Investment entities

KEY TERM

An **investment entity** is an entity that:

(a) Obtains funds from one or more investors for the purpose of providing those investors with investment management services

(b) Commits to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both, and

(c) Measures and evaluates the performance of substantially all of its investments on a fair value basis.

The most common types of investment entity are private equity organisations, venture capital organisations, pension funds and other investment funds.

If a parent company meets the definition of an investment entity, it is prohibited from consolidating its subsidiaries (other than as noted below) or applying acquisition accounting (SFRS(I) 3) when it obtains control of another entity.

Instead it must measure its investments at fair value in accordance with SFRS(I) 9 **Financial Instruments**.

An exception to this requirement is made where an investment entity parent company has subsidiaries that provide services relating to its own activities. Such subsidiaries are consolidated as normal in accordance with this standard and SFRS(I) 3.

In the case of a vertical group in which the subsidiary is an investment entity, but the parent company is not, the parent company must still consolidate the sub-subsidiaries as normal:

Here P prepares consolidated financial statements to include S, SS1 and SS2.

SFRS(I) 10 clarifies certain aspects of the application of the consolidation exemption for investment entities:

1. The exemption from preparing consolidated financial statements described in section 2.2.2 above is still available to a parent even where the ultimate (or intermediate) parent is an investment entity and measures all of its subsidiaries at fair value rather than produce consolidated financial statements.

2. SFRS(I) 10 requires that where a subsidiary provides services related to the operating activities of an investment entity, it is consolidated as normal. This does not apply unless:
   - The subsidiary itself is not an investment entity, and
   - The subsidiary's main purpose is to provide services and activities that are related to the investment activities of the investment entity parent.
2.3 Consolidation procedures

Consolidated financial statements are prepared by combining the assets, liabilities, income and expenses of a parent and its subsidiaries on a line by line basis and:

- Eliminating the carrying amount of the parent's investment in each subsidiary against the subsidiaries' equity
- Cancelling any intragroup balances and transactions
- Recognising a non-controlling interest where the parent does not own 100% of the equity in each subsidiary

2.3.1 Different reporting dates

In most cases, all group companies will prepare accounts to the same reporting date. One or more subsidiaries may, however, prepare accounts to a different reporting date from the parent and the bulk of other subsidiaries in the group.

In such cases the subsidiary may prepare additional statements to the reporting date of the rest of the group, for consolidation purposes. If this is not possible, the subsidiary's accounts may still be used for the consolidation, provided that the gap between the reporting dates is three months or less.

Where a subsidiary's accounts are drawn up to a different accounting date, adjustments should be made for the effects of significant transactions or other events that occur between that date and the parent's reporting date.

2.3.2 Uniform accounting policies

Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances.

Adjustments must be made where members of a group use different accounting policies, so that their financial statements are suitable for consolidation.

2.3.3 Date of inclusion/exclusion

The results of subsidiary undertakings are included in the consolidated financial statements from:

(a) The date of ‘acquisition’, ie the date on which the investor obtains control
(b) The date of ‘disposal’, ie the date when the investor loses control

Once an investment is no longer a subsidiary, it should be treated as appropriate in accordance with the table given in section 1.3 of this chapter.

2.4 Accounting for subsidiaries and associates in the parent's financial statements

A Singapore parent company will usually produce its own single company financial statements (other countries may have different legal requirements). In these statements, governed by SFRS(I) 1-27 Separate Financial Statements, investments in subsidiaries, joint arrangements and associates included in the separate financial statements should be accounted for either:

(a) At cost
(b) In accordance with SFRS(I) 9 Financial Instruments; or
(c) Using the equity method (SFRS(I) 1-28 Investments in Associates and Joint Ventures).

This is an accounting policy choice for each category of investment.
Where subsidiaries are classified as held for sale in accordance with SFRS(I) 5 Non-current Assets Held for Sale and Discontinued Operations they should be accounted for in accordance with the requirements of that standard (see Chapter 21).

SECTION SUMMARY
A parent controls another entity and should consolidate it when the parent has power over the entity, has exposure to variable returns from the entity and can use the power to influence the returns. An investment entity must not consolidate the investments that it controls. Consolidated financial statements involve combining assets, liabilities, income and expenses on a line by line basis subject to consolidation adjustments.

3  SFRS(I) 3 Business Combinations

SECTION INTRODUCTION
SFRS(I) 3 Business Combinations provides guidance on the measurement of net assets acquired in a business combination, the non-controlling interest and goodwill arising on a business combination.

3.1 Objective of SFRS(I) 3
As we have seen, SFRS(I) 10 deals with the principles and mechanics of consolidation. SFRS(I) 3 must also be applied in the preparation of consolidated financial statements and this standard establishes the principles and requirements for how a company which acquires a business (which may be a subsidiary) should:

(a) Recognise and measure in its financial statements the identifiable assets and liabilities of the acquiree
(b) Recognise and measure any non-controlling interest in the acquiree
(c) Recognise and measure the goodwill acquired in the business combination or a gain from a bargain purchase
(d) Determine what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination

3.2 Scope
SFRS(I) 3 applies to business combinations, in other words any combination where one entity acquires control of another.

It is therefore not relevant to:

(a) The accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself
(b) The acquisition of an asset or assets that do not constitute a business
(c) A combination of businesses or entities under common control.

In addition, SFRS(I) 3 does not apply to the acquisition of a subsidiary that is required to be measured at fair value through profit or loss by an investment entity.
3.3 Definitions

In addition to those definitions which we have already seen, SFRS(I) 3 (in Appendix A) provides the following definitions relevant to business combinations:

**KEY TERM**

**ACQUIREE** The business or businesses that the **acquirer** obtains control of in a **business combination**.

**ACQUIRER** The entity that obtains control of the **acquiree**.

**BUSINESS COMBINATION** A transaction or other event in which an **acquirer** obtains control of one or more **businesses**.

**CONTINGENT CONSIDERATION** Usually, an obligation of the **acquirer** to transfer additional assets or **equity interests** to the former owners of an **acquiree** as part of the exchange for control of the **acquiree** if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

**EQUITY INTERESTS** Broadly used in SFRS(I) 3 to mean ownership interests of investor owned entities and owner, member or participant interests of mutual entities.

**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. (SFRS(I) 13)

**NON-CONTROLLING INTEREST** The equity in a subsidiary not attributable, directly or indirectly, to a parent.

**GOODWILL** An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

3.4 Identifying a business combination

SFRS(I) 3 requires entities to determine whether a transaction or other event is a business combination by applying the definition in the standard. If the assets acquired are not a business, the transaction is accounted for as a normal asset acquisition.

A business is:

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants (SFRS(I) 3 Appendix A).

The three components of a business are inputs, processes and outputs.

Further guidance on what constitutes a business can be found in SFRS(I) 3 Appendix B para B7–B12.

3.5 The acquisition method

Entities must account for each business combination by applying the acquisition method. This requires:

(a) Identifying the acquirer

(b) Determining the acquisition date

(c) Recognising and measuring the identifiable assets acquired, liabilities assumed and any non-controlling interest (NCI)

(d) Recognising and measuring goodwill or a gain from a bargain purchase
3.5.1 Identifying the acquirer

The acquirer is generally the party that obtains control. SFRS(I) 3 requires that one of the entities in the business combination is identified as the acquirer ie a business combination is not a merger.

SFRS(I) 3 also addresses a certain type of acquisition, known as a reverse acquisition or takeover. For example, a private entity (Company B) may arrange to have itself ‘acquired’ by a smaller public entity (Company A) as a means of obtaining a stock exchange listing. The number of shares issued by Company A as consideration to the shareholders of Company B is so great that control of the combined entity after the transaction is with the shareholders of Company B.

In legal terms Company A may be regarded as the parent entity, but SFRS(I) 3 states that, as it is the Company B shareholders who control the combined entity, Company B should be treated as the acquirer. Company B should apply the acquisition (or purchase) method to the assets and liabilities of Company A.

![Diagram: Before and After reverse acquisition](image)

After a reverse acquisition, even though Company A now holds 100% of Company B, Company B is deemed to be the ‘acquirer’ in this acquisition. It is possible that not all of the original owners of Company B would want to take shares in company A. If this is the case then these owners are treated as non-controlling interests (see SFRS(I) 3 B23–B24).

3.5.2 Determining the acquisition date

This is the date on which control of the acquiree is obtained. It is generally the date the consideration is legally transferred, the assets are acquired and the liabilities assumed. This is referred to as the closing date. Control might be obtained earlier or later than the closing date as specified in the sale and purchase agreement. This might be the case, for example where there is a written agreement which provides that control is transferred at an alternative date.

3.5.3 Recognising and measuring assets, liabilities and the NCI

At the acquisition date the acquirer should recognise separately:

- The identifiable assets acquired
- The liabilities assumed
- Any non-controlling interest
- Goodwill

To qualify for recognition, assets and liabilities should meet the definition of assets and liabilities in the Conceptual Framework and be part of the business combination rather than a separate transaction.

Most assets and liabilities are measured at fair value. The exceptions are discussed later.

The recognition of assets, liabilities and the non-controlling interest is an integral part of the goodwill calculation and therefore this is introduced in section 3.6.
3.5.4 Recognising and measuring goodwill or a gain from a bargain purchase

The calculation of goodwill is discussed in more detail in the next section. Goodwill may be positive or negative (a 'gain on a bargain purchase'). Accounting for positive and negative goodwill is discussed in more detail in Chapter 9 Inventories and intangible non-current assets.

3.6 Goodwill

As we have seen, goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

It is, in effect, the excess paid by an acquirer, over the fair value of the net assets to acquire a business. It is created by factors such as a good reputation and quality customer service.

On a business combination, goodwill is measured as:

\[
\text{Consideration transferred (equates to purchase price)} \times X
\]

\[
\text{Non-controlling interest} \times X
\]

\[
\text{Less: the net acquisition date fair values of identifiable assets acquired and liabilities assumed} \times (X)
\]

\[
\text{Goodwill} \times X
\]

The following sections of this chapter deal with each element of the calculation in turn. (One further complication, relating to interests in the acquiree already held, will be introduced in Chapter 28.)

**Example**

Mr A owns 100% of an interior design company A Design Pte Ltd with paid up capital $100,000 and Mr C owns 100% of a furnishing company C Furniture Pte Ltd with paid up capital $300,000. Both shareholders decided to work together by A Design Pte Ltd acquiring the entire share capital in C Furniture Pte Ltd for $400,000. At the date of acquisition, the fair value of net assets in C Furniture Pte Ltd was $350,000.

What is the goodwill at acquisition?

**Solution**

\[
\begin{align*}
\text{Cost of investment (purchase consideration)} & \quad 400,000 \\
\text{Non-controlling interest} & \quad 0 \\
\text{Less: fair value of net assets acquired} & \quad (350,000) \\
\hline
\text{Goodwill at acquisition} & \quad 50,000
\end{align*}
\]

3.7 Consideration transferred

Consideration for a business combination (ie the purchase price) may be in the form of cash, shares, debt instruments or other assets. It may be paid immediately or deferred; where it is deferred, payment may be contingent upon a particular event. Consideration when deferred should be carried at net present value, using the acquirer's cost of capital.

The basic principle of SFRS(I) 3 is that consideration is measured at fair value. Fair value is determined in accordance with SFRS(I) 13 *Fair Value Measurement*.

3.7.1 Contingent consideration

SFRS(I) 3 requires that contingent consideration, measured at fair value, is recognised at the acquisition date.
The acquirer may be required to pay contingent consideration in the form of equity, a debt instrument or in cash. Debt instruments and equity are presented in accordance with SFRS(I) 1-32 Financial Instruments: Presentation. Contingent consideration may occasionally be an asset, for example if the consideration has already been transferred and the acquirer has the right to the return of part of it, an asset may be recognised in respect of that right.

**Example**

Bay Building Ltd acquires all of the ordinary share capital of Island Inventories Pte Ltd on 1 August 20X3. The terms of the deal are as follows:

- $20 million cash consideration is payable immediately
- Additional cash consideration will be paid on 30 July 20X5 if Island Inventories achieves profits in excess of $3 million in the two years post-acquisition. The amount of additional consideration is calculated on a sliding scale dependent on the level of total profits in excess of $3 million.

The fair value of the contingent cash consideration at the acquisition date, calculated using a simulation model is $3.5 million.

The fair value of the net assets of Island Inventories on the acquisition date is $18.9 million.

(a) What goodwill arises on the acquisition?

(b) How is the acquisition recorded in the individual financial statements of Bay Building Ltd?

**Solution**

<table>
<thead>
<tr>
<th>(a)</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash consideration</td>
<td>20,000</td>
</tr>
<tr>
<td>Contingent consideration</td>
<td>3,500</td>
</tr>
<tr>
<td>Fair value of identifiable net assets</td>
<td>(18,900)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>4,600</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(b)</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>CREDIT</td>
</tr>
<tr>
<td>Investment</td>
<td>Cash</td>
</tr>
<tr>
<td>23,500,000</td>
<td>20,000,000</td>
</tr>
</tbody>
</table>

3.7.2 Post-acquisition changes in the fair value of the contingent consideration

The treatment depends on the circumstances:

(a) If, during the measurement period (which shall not be greater than one year from the acquisition date – see section 3.10), the change in fair value is due to additional information obtained that affects the position at the acquisition date, goodwill is re-measured.

(b) If the change is due to events that took place after the acquisition date, for example meeting earnings targets, or is identified after the measurement period:

(i) Contingent consideration classified as equity is not re-measured and its subsequent settlement is accounted for within equity.

(ii) Other contingent consideration that is within the scope of SFRS(I) 9 is measured at fair value at each reporting date and changes in fair value are recognised in profit or loss in accordance with SFRS(I) 9.
(iii) Other contingent consideration that is not within the scope of SFRS(I) 9 is measured at fair value at each reporting date and changes in fair value are recognised in profit or loss in accordance with SFRS(I) 9.

If new assets or liabilities are identified during the measurement period these should also be recorded and consequent adjustments made retrospectively.

It is possible that the previous amounts recorded could still be adjusted retrospectively but only by applying SFRS(I) 1-8 where there is an accounting error.

3.7.3 Acquisition-related costs

Costs relating to an acquisition may include:

- Finders' fees
- Advisory, legal, accounting, valuation and other professional fees
- The costs of issuing debt or equity securities

Generally these costs must be recognised as an expense in the consolidated accounts when incurred. They are not permitted to be treated as part of the cost of the combination and do not therefore contribute to goodwill. The exception to this is the cost to issue debt or equity securities which must be recognised in accordance with SFRS(I) 1-32 Financial Instruments: Presentation and SFRS(I) 9 Financial Instruments. In the parent company's individual financial statements it is likely that the amounts would be capitalised as part of the cost of the investment in the subsidiary.

3.7.4 Pre-existing relationships

A pre-existing relationship between the acquirer and the acquiree is one which existed before they contemplated the business combination. This relationship may be contractual (e.g., licensor and licensee) or non-contractual (e.g., plaintiff and defendant). Consideration in respect of a pre-existing relationship between an acquirer and acquiree does not form part of the consideration transferred on a business combination, and is not included in the calculation of goodwill. The acquirer must only recognise consideration transferred for the acquiree and the assets and liabilities acquired and assumed. (Further guidance is given in SFRS(I) 3 Appendix B Paragraphs B51–53.)

3.8 Non-controlling interest

As we have seen, the non-controlling interest forms part of the calculation of goodwill. The question now arises as to how it should be measured.

SFRS(I) 3 provides a choice; for each business combination, the acquirer shall measure any non-controlling interest in the acquiree either:

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

Where non-controlling interest shareholders are not entitled to a proportionate share of the net assets on liquidation, the non-controlling interest must be measured at fair value.

3.8.1 NCI at fair value

SFRS(I) 3 suggests that the fair value of the non-controlling interest should be measured, if possible, by reference to a quoted price in an active market for equity shares not held by the acquirer. Another valuation technique should be used if this is not available, however the standard does not specify which technique. SFRS(I) 13 Fair Value Measurement provides more details of how to identify fair values.

The standard also states that the fair value of the NCI shareholding and the parent shareholding on a per-share basis are likely to be different. This is due to the inclusion of a control premium in the price of a share held by the parent.
The non-controlling interest at fair value will usually be different from the non-controlling interest as a proportionate share of the acquiree's net assets. The difference is goodwill attributable to the non-controlling interest, which may be, but often is not, proportionate to goodwill attributable to the parent. Where the fair value method is used the measurement of the NCI is effectively brought into line with the measurement of the consideration and the acquiree's net assets used in the goodwill calculation. As a result goodwill on acquisition calculated using this method will represent 100% of the goodwill in the acquiree. This method is therefore sometimes referred to as the 'full goodwill' method.

### 3.8.2 NCI as proportion of net assets

Where the NCI is measured as a proportion of the fair value of the identifiable assets of the acquiree, the goodwill calculated relates only to the parent company and does not include any NCI goodwill. This method is sometimes referred to as the 'partial goodwill' method.

#### Example

On 31 December 20X8, P Ltd acquired four million of the five million ordinary shares of Y Ltd, paying $10 million in cash. On that date, the fair value of Y’s net assets was $7.5 million.

It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Calculate goodwill on the acquisition.

<table>
<thead>
<tr>
<th>Solution</th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>10,000</td>
</tr>
<tr>
<td>Non-controlling interest: 20% × $7.5m</td>
<td>1,500</td>
</tr>
<tr>
<td>Net assets acquired</td>
<td>(7,500)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>4,000</td>
</tr>
</tbody>
</table>

#### Example

The facts are the same as the example above, however this time it is the group's policy to value the non-controlling interest at fair value. The market price of the shares held by the non-controlling shareholders just before the acquisition was $2.00.

Calculate goodwill on the acquisition.

<table>
<thead>
<tr>
<th>Solution</th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>10,000</td>
</tr>
<tr>
<td>Non-controlling interest 1m × $2</td>
<td>2,000</td>
</tr>
<tr>
<td>Net assets acquired</td>
<td>(7,500)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>4,500</td>
</tr>
</tbody>
</table>
Of the $4.5 million goodwill, $4 million is attributable to the parent company (being the amount calculated in example 1) and $500,000 is attributable to the NCI. This may be seen more clearly if the calculation is laid out differently:

<table>
<thead>
<tr>
<th></th>
<th>Parent</th>
<th>NCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration/Fair value</td>
<td>10,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Net assets acquired</td>
<td>(6,000)</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>4,000</td>
<td>500</td>
</tr>
</tbody>
</table>

3.8.3 Non-controlling interest at the year-end

The fair value of the non-controlling interest is only relevant at the acquisition date. The non-controlling interest at any subsequent date is calculated as:

\[
\text{NCI at acquisition date (as measured in the calculation of goodwill)} \times \frac{\text{NCI share of post-acquisition movement in reserves}}{\text{NCI}}
\]

In other words, regardless of which method is initially used to measure the non-controlling interest, the post-acquisition increase (or decrease) is the same.

3.8.4 Choice of method

An entity may choose whether to measure the NCI at fair value or as a proportion of the net assets of the acquiree on a transaction by transaction basis. Points to consider when choosing a method include the following:

(a) Measurement of the fair value of the NCI may be a difficult exercise when the acquiree's shares are not quoted

(b) Measurement at fair value will increase the initial amount of goodwill (assuming the NCI value is positive)

(c) Impairment testing is simpler where the ‘full goodwill’ method is used

3.9 Fair value of identifiable net assets acquired

The general rule under SFRS(I) 3 is that the subsidiary's identifiable assets and liabilities must be measured at fair value except in limited, stated cases. The exceptions are discussed later.

SFRS(I) 13 *Fair Value Measurement* provides extensive guidance on how the fair value of assets and liabilities should be established (see Chapter 3).

Fair values may be incorporated into the books of the acquiree in either of the following ways:

(a) The subsidiary company might incorporate any necessary revaluations in its own books of account where allowed by the standards. In this case, we can proceed directly to the calculation of goodwill and in turn the consolidation, taking asset values and reserves figures straight from the subsidiary company's statement of financial position.

(b) The revaluations may be made as a consolidation adjustment without being incorporated in the subsidiary company's books. In this case, we must make the necessary adjustments to the subsidiary's statement of financial position as a working. Only then can we proceed to the consolidation.

The identifiable assets and liabilities that are recognised in a business combination include all of the acquiree's assets and liabilities that the acquirer assumes. This will include items not recognised in the financial statements of the acquiree as these items may not meet the criteria for recognition in the
acquiree’s financial statements, for example, certain intangible assets (e.g., internally generated brands) and contingent liabilities (that can be reliably measured). Another example of such an intangible asset is customer contracts which have been secured by the acquiree which will result in a future income stream to the acquiree and acquirer on a consolidated basis.

The identification of such assets and liabilities is important because it attempts to mirror, as closely as possible, all the factors that have been considered when a consideration transferred (more commonly known as purchase price) was determined. This process of allocating the consideration transferred is known as ‘Purchase Price Allocation’.

### Example

Z Ltd acquired 80% of the ordinary shares of L Ltd on 1 September 20X3 at a cost of $25 million. The book value of the net assets of L Ltd on this date was $22 million, and included land with a carrying value of $2 million and a fair value of $4.5 million. L Ltd does not apply the SFRS(I) 1-16 revaluation model.

What goodwill arises on the combination assuming that the non-controlling interest is measured as a proportion of net assets?

#### Solution

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>4,900</td>
<td></td>
</tr>
<tr>
<td>FV of identifiable net assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carrying amount of net assets</td>
<td>22,000</td>
<td></td>
</tr>
<tr>
<td>FV adjustment (4.5m – 2m)</td>
<td>2,500</td>
<td>24,500</td>
</tr>
<tr>
<td>Goodwill</td>
<td>5,400</td>
<td></td>
</tr>
</tbody>
</table>

SFRS(I) 3 includes some specific guidance on the recognition and measurement of identifiable assets acquired and liabilities assumed. This is discussed in the following sections.

### 3.9.1 Restructuring and future losses

An acquirer should not recognise liabilities for future losses or other costs expected to be incurred as a result of the business combination.

SFRS(I) 3 explains that a plan to restructure a subsidiary following an acquisition is not a present obligation of the acquiree at the acquisition date. Neither does it meet the definition of a contingent liability. Therefore, an acquirer should not recognise a liability for such a restructuring plan as part of allocating the cost of the combination unless the subsidiary was already committed to the plan before the acquisition.

This prevents creative accounting. An acquirer cannot set up a provision for restructuring or future losses of a subsidiary and then release this to profit or loss in subsequent periods in order to reduce losses or smooth profits.

### 3.9.2 Intangible assets

The acquiree may have intangible assets, such as development expenditure. These can be recognised separately from goodwill only if they are identifiable. An intangible asset is identifiable only if it:

(a) is separable, i.e., capable of being separated or divided from the entity and sold, transferred, or exchanged, either individually or together with a related contract, asset or liability; or

(b) arises from contractual or other legal rights.
An example of an identifiable intangible asset is customer contracts which have been secured by the acquiree. These will result in future income streams to the acquiree and acquirer on a consolidated basis. They also satisfy the contractual-legal criterion (see SFRS(I) 3 IE 26).

### 3.9.3 Exceptions to the recognition or measurement principles

As we have seen, SFRS(I) 3 requires that at the acquisition date:

- Identifiable assets acquired and liabilities assumed are **recognised**, provided that they:
  - (i) meet the definition of an asset or liability in the [Conceptual Framework](#)
  - (ii) are part of the business acquired rather than a separate transaction.

- Identifiable assets acquired and liabilities assumed are **measured** at their acquisition date fair value.

There are certain exceptions to either one or both of these requirements, as follows:

<table>
<thead>
<tr>
<th>Recognition</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent liabilities</td>
<td>Reacquired rights</td>
</tr>
<tr>
<td>Income taxes (apply SFRS(I) 1-12)</td>
<td>Share-based payment awards (apply SFRS(I) 2)</td>
</tr>
<tr>
<td>Employee benefits (apply SFRS(I) 1-19)</td>
<td>Assets held for sale (apply SFRS(I) 5)</td>
</tr>
<tr>
<td>Indemnification assets (measurement should be consistent with the measurement of the indemnified item, for example an employee benefit or a contingent liability.)</td>
<td>Regulatory deferral account balances</td>
</tr>
</tbody>
</table>

- **Reacquired rights** are valued on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value.

- **Contingent liabilities** of the acquiree are recognised if their **fair value can be measured reliably**. A **contingent liability** must be recognised even if the outflow is not probable, provided there is a present obligation.

This is a departure from the normal rules in SFRS(I) 1-37 *Provisions, Contingent Liabilities and Contingent Assets*; contingent liabilities are not normally recognised, but only disclosed and this is what would happen in the subsidiary’s own financial statements.

After their initial recognition, the acquirer should measure contingent liabilities that are recognised separately at the higher of:

- (a) The amount that would be recognised in accordance with SFRS(I) 1-37; and
- (b) The amount initially recognised, less (if appropriate), the cumulative amount of income recognised in accordance with the principles of SFRS(I) 15 *Revenue from Contracts with Customers*.

### 3.10 Adjustments after the initial accounting is complete

Sometimes the fair values of the acquiree’s identifiable assets, liabilities or contingent liabilities or the cost of the combination can only be measured **provisionally** by the end of the period in which the
combination takes place. In this situation, the acquirer should account for the combination using those provisional values. The acquirer should recognise any adjustments to those provisional values as a result of completing the initial accounting:

(a) Within 12 months of the acquisition date; and
(b) From the acquisition date (ie retrospectively).

The above is the case so long as the adjustment is due to new information about conditions existing facts and circumstances at the acquisition date. This means that:

(a) The carrying amount of an item that is recognised or adjusted as a result of completing the initial accounting shall be calculated as if its fair value at the acquisition date had been recognised from that date.

(b) Goodwill should be adjusted from the acquisition date by an amount equal to the adjustment to the fair value of the item being recognised or adjusted.

Any further adjustments after the initial accounting is complete should be recognised only to correct an error in accordance with SFRS(I) 1-8 Accounting Policies, Changes in Accounting Estimates and Errors. Any subsequent changes in estimates are dealt with in accordance with SFRS(I) 1-8 (ie, the effect is recognised in the current and future periods). SFRS(I) 1-8 requires an entity to account for an error correction retrospectively, and to present financial statements as if the error had never occurred by restating the comparative information for the prior period(s) in which the error occurred.

3.11 Disclosure

SFRS(I) 3 requires disclosure of information which enables users of the financial statements to evaluate the nature and financial effect of a business combination. Information provided when a business combination takes place in a reporting period should include:

- Details of the acquiree and acquisition including date and reasons for it
- A description of factors contributing to goodwill
- Details of consideration transferred
- Details of assets and liabilities acquired
- Measurement basis applied to the NCI and how fair value was established where relevant

**Question 24.1**

Puddle acquired control of a supplier, Sun, through the acquisition of a 90% equity shareholding in that company on 1 May 20X4. Puddle elected to measure the NCI at fair value. The agreed consideration was:

- $14 million cash payable on the acquisition date
- $2 million loan notes payable on the first anniversary of the acquisition and contingent upon Sun achieving stated earnings targets.
- 1 share in Puddle issued on the acquisition date for every 20 acquired in Sun. The quoted share price of Puddle at 1 May 20X4 was $15.80 and the fair value of a share in Sun, determined using an income based valuation technique, was $7.50.

At 1 May 20X4, the fair value of the contingent consideration was determined to be $2.1 million; at 31 December 20X4, as a result of the poor performance of Sun, the fair value of this consideration was considered to be $1.8 million.

At the acquisition date, Sun’s share capital amounted to 3 million shares with a carrying amount of $5 million and the company’s reported reserves were $10.4 million. The financial statements of Sun prepared as at the acquisition date included:

(a) $600,000 relating to licensing fees paid to Puddle for the right to use technology developed by that company. The remaining licence term is 6 years. Puddle has recently charged other suppliers $1 million for licences for a 10 year period.
(b) A balance of $100,000 due from Puddle in respect of goods delivered. This was settled as part of the acquisition with $100,000 of the agreed cash consideration paid to Sun.

(c) A $200,000 provision in respect of a legal case brought against Puddle by a customer. The $200,000 carrying amount of the provision was estimated at 31 December 20X3; at the acquisition date, legal advisers suggested that a more accurate measurement of the expected settlement was $230,000. The case was subsequently settled at $190,000 in October 20X4.

(d) A property with a carrying amount of $2 million. The property is currently used for industrial purposes and has an estimated market value of $4.3 million. Surveyors have advised Puddle that the property would achieve $4.6 million if sold on the basis of conversion to ‘warehouse apartments’.

Required

(a) State the journal entry required in Puddle’s accounts on 1 May 20X4 to recognise the acquisition
(b) Calculate goodwill arising on the acquisition of Sun by Puddle at 1 May 20X4.
(d) Explain how the contingent consideration is accounted for at 31 December 20X4.
(c) State the standing journal required on consolidation to recognise goodwill at 31 December 20X4 and subsequent period ends.

SECTION SUMMARY

SFRS(I) 3 requires that goodwill is calculated as the difference between consideration transferred plus the non-controlling interest and the fair value of identifiable net assets acquired. Consideration includes contingent consideration measured at fair value, but not acquisition related costs which must be expensed. The non-controlling interest may be measured at fair value or as a proportion of net assets. This choice is available on a transaction by transaction basis.

4 SFRS(I) 12 Disclosure of Interests in Other Entities

SECTION INTRODUCTION

SFRS(I) 12 Disclosure of Interests in Other Entities requires disclosure of a reporting entity’s interests in other entities.

The objective of SFRS(I) 12 is to require entities to disclose information that enables the user of the financial statements to evaluate the nature of, and risks associated with, interests in other entities, and the effects of those interests on its financial position, financial performance and cash flows.

This is particularly relevant in light of the most recent financial crisis and recent accounting scandals. The ASC believes that better information about interests in other entities is necessary to help users to identify the profit or loss and cash flows available to the reporting entity and to determine the value of a current or future investment in the reporting entity.
The standard prescribes disclosures about judgments and assumptions, together with disclosures in respect of:

- Interests in subsidiaries
- Interests in investment entities
- Interests in joint arrangements and associates
- Interests in unconsolidated structured entities (an entity which is designed so that voting or similar rights are not the dominant factor in establishing control)

As with other standards, SFRS(I) 12 contains a list of defined terms and draws on definitions used in other SFRS(I)s.

The disclosure requirements in the standard (except for those relating to summarised financial information) apply to interests in other entities even if they are classified as held for sale, held for distribution or discontinued operations.

### 4.1 Significant judgments and assumptions

An entity that has investments in other entities must disclose:

(a) The **significant judgments and assumptions** made in determining whether the entity has control, joint control or significant influence over the other entities, and in determining the type of joint arrangement

(b) The **significant judgments and assumptions** made in determining that an entity is an investment entity

### 4.2 Disclosure of subsidiaries

The following disclosures are required in respect of subsidiaries:

(a) The interest that non-controlling interests have in the group’s activities and cash flows, including the name of relevant subsidiaries, their principal place of business, and the interest and voting rights of the non-controlling interests

(b) Nature and extent of significant restrictions on an investor's ability to use group assets and liabilities

(c) Nature of the risks associated with an entity’s interests in consolidated structured entities, such as the provision of financial support

(d) Consequences of changes in ownership interest in subsidiary (whether control is lost or not)

### 4.3 Disclosure of investment entities

An investment entity that measured all of its subsidiaries at fair value should provide the following disclosures:

(a) The fact that the investment entity exception has been applied

(b) Details of each unconsolidated subsidiary

(c) Any significant restrictions on the ability of an unconsolidated subsidiary to transfer funds to the investment entity and any commitments or intentions to provide support to an unconsolidated subsidiary

(d) Details of any support provided to an unconsolidated subsidiary in the period
4.4 Disclosure of associates and joint arrangements

The following disclosures are required in respect of associates and joint arrangements:

(a) Nature, extent and financial effects of an entity’s interests in associates or joint arrangements, including name of the investee, principal place of business, the investor’s interest in the investee, method of accounting for the investee and restrictions on the investee’s ability to transfer funds to the investor.

(b) Risks associated with an interest in an associate or joint venture.

(c) Summarised financial information, with more detail required for joint ventures than for associates.

The required disclosures can be seen in the Banyan Tree Holdings Limited Annual Report 2017. Notes 16, 17 and 18 on pages 156 to 169 provide detail on the Group’s subsidiaries, joint ventures and associates respectively.


SECTION SUMMARY

SFRS(I) 12 requires disclosure of significant judgments and assumptions made in respect of accounting for investments together with details of subsidiaries, investment entities, associates and joint arrangements.

5 Current developments

SECTION INTRODUCTION

The IASB has recently completed a post-implementation review of IFRS 3 (SFAS(I) 3).

The IASB completed a post-implementation review of IFRS 3 Business Combinations in 2015. Post implementation reviews are part of the IFRS Foundation due process. The aim of the review was to assess whether IFRS 3 (SFAS(I) 3) provides useful information to users, is being applied consistently and whether any unexpected costs of implementation have arisen.

The review concluded that there was general support for IFRS 3 (SFAS(I) 3), however additional research was needed in certain areas. As a result the IASB added a project to its agenda focusing on the definition of a business.

This project resulted in the issue of ED/2016/1 Definition of a Business and Accounting for Previously Held Interests – Proposed amendments to IFRS 3 and IFRS 11 in June 2016. This project was subsequently split into two parts; that part relating to previously held interests is now complete and is reflected in the content of Chapter 28. The part relating to the definition of a business is ongoing and is discussed below.

The definition of a business is important because the requirements of IFRS 3 (SFAS(I) 3) are applicable to the acquisition of a business, but the acquisition of a group of assets is outside the scope of the standard. Therefore the acquisition of a business results in goodwill, however the acquisition of a group of assets does not.

This ED proposed amendments to the implementation guidance of IFRS 3 to clarify that:
(a) In order to be considered a business, an acquired set of activities and assets must include at least an input and a substantive process that together have the ability to contribute to the creation of outputs.

(b) If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, then the set of activities and assets is not a business.

(c) The presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive and the associated assets and activities are a business. It cannot, however, be presumed that a business exists just because goodwill arises, or that there is no business because there is no goodwill.

The amendments provide further detailed guidance, applicable when determining whether a process is substantive.

SECTION SUMMARY

A post implementation review of IFRS 3 (SFRS(I) 3) has recently been completed. As a result of the review, the IASB has undertaken work to improve the standard; ED/2016/1 Definition of a Business and Accounting for Previously Held Interests – Proposed amendments to IFRS 13 and IFRS 11 was issued in June 2016.
Chapter Roundup

**Group accounts**
- Power
- Subsidiary
  - Control
    - Exposure to variable returns
    - Influence over returns
      - Direct shareholding
      - Indirect shareholding
      - Potential voting rights

**Goodwill**
- Consideration
- Non-controlling interest
- Fair value of identifiable assets and liabilities
  - Fair value
  - Proportion of fair value of net assets
  - At fair value

**SFRS(I) 12 Disclosure**

**Other terms**
- Acquisition related costs expenses
- Contingent
Quick Quiz

1. What three elements establish control?
2. What is a non-controlling interest?
3. How is the non-controlling interest on acquisition to be measured?
4. How should an investment in a subsidiary be accounted for in the separate statement of financial position of the parent?
5. In a business combination how is the acquirer identified?
Answers to Quick Quiz

1  
(a) Power over the entity
(b) Exposure to variable returns
(c) Ability to use power to influence returns

2  
The equity in the subsidiary not attributable, directly or indirectly to a parent (SFRS(I) 3 Appendix A).

3  
Either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets.

4  
At cost, in accordance with SFRS(I) 9 or by applying equity accounting.

5  
The acquirer is the entity that obtains control of the other combining entities or businesses.

Answers to Questions

24.1  
(a) The investment in Sun is a financial asset investment in Puddle's separate financial statements and as such is measured initially at its fair value:

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (note 1)</td>
<td>13,900</td>
</tr>
<tr>
<td>Loan notes (at fair value)</td>
<td>2,100</td>
</tr>
<tr>
<td>Shares issued (note 2)</td>
<td>2,133</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>18,133</strong></td>
</tr>
</tbody>
</table>

In Puddle's financial statements the investment is recognised by ($):

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Investment in Sun (financial asset)</td>
</tr>
<tr>
<td>DEBIT</td>
<td>Trade payable</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Cash</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Loan notes to be issued</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Share capital</td>
</tr>
</tbody>
</table>

To record the acquisition of the subsidiary and settlement of the trade account with Sun.

Notes:

1  
$100,000 of the cash payment is in respect of a pre-existing relationship, being the balance due from Puddle for goods supplied. This does not form part of the consideration for the acquisition.

2  
The share consideration is recognised at fair value, equating to the number of shares issued in Puddle multiplied by the quoted share price:

\[
\frac{90\% \times 3m}{20} = 135,000 \text{ shares}
\]

at fair value of $15.80 per share = $2,133,000
(b) Goodwill arising on acquisition

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred (cost of investment) – part (a)</td>
<td>18,133</td>
<td></td>
</tr>
<tr>
<td>Fair value of the NCI (10% × 3m shares × $7.50)</td>
<td></td>
<td>2,250</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>20,383</td>
<td></td>
</tr>
</tbody>
</table>

Identifiable net assets at acquisition date:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>5,000</td>
</tr>
<tr>
<td>Reserves as reported</td>
<td>10,400</td>
</tr>
<tr>
<td>Trade receivable settled replaced by cash</td>
<td>0</td>
</tr>
<tr>
<td>Adjustment to carrying amount of provision ($230,000 – $200,000)</td>
<td>(30)</td>
</tr>
<tr>
<td>Fair value adjustment to property ($4.6 million – $2 million)</td>
<td>2,600</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>(17,970)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>2,413</td>
</tr>
</tbody>
</table>

Notes:

1. No adjustment is made to Sun's financial statements in respect of the re-acquired right. SFRS(I) 3 requires that this is measured based on the remaining contractual term of the contract regardless of the possibility of contract renewals.
2. The trade receivable account of $100,000 with Puddle has been settled, however there is no change to net assets as Sun receives cash instead.
3. The fair value of the provision is the acquisition date estimate of the outflow of resources required to settle the obligation, being $230,000
4. The property is measured at fair value in accordance with SFRS(I) 13. Therefore the highest and best use of the property is considered and the fair value is $4.6 million.

(c) At 31 December 20X4:

The contingent consideration is remeasured to fair value in the financial statements of Puddle, with any gain or loss recognised in profit or loss. This does not, therefore, affect the carrying amount of goodwill ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan notes to be issued 300,000</td>
<td>Profit or loss 300,000</td>
</tr>
</tbody>
</table>

To remeasure the contingent consideration.

(d) Standing journal

Sun's legal case is settled before the period end and within the ‘measurement period, which lasts a maximum of 12 months after the acquisition date. The settlement of the case provides new information about facts and circumstances that existed at the acquisition date, and therefore goodwill is adjusted to reflect the settlement amount:

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred (cost of investment) – part (a)</td>
<td>18,133</td>
<td></td>
</tr>
<tr>
<td>Fair value of the NCI (10% × 3m shares × $7.50)</td>
<td></td>
<td>2,250</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>20,383</td>
<td></td>
</tr>
</tbody>
</table>

Identifiable net assets at acquisition date:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>5,000</td>
</tr>
<tr>
<td>Reserves as reported</td>
<td>10,400</td>
</tr>
<tr>
<td>Trade receivable settled replaced by cash</td>
<td>0</td>
</tr>
<tr>
<td>Adjustment to carrying amount of provision ($200,000 – $190,000)</td>
<td>10</td>
</tr>
<tr>
<td>Fair value adjustment to property ( as part (b))</td>
<td>2,600</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>(18,010)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>2,373</td>
</tr>
</tbody>
</table>
The standing journal is therefore ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>Investment in Sun</td>
<td>$18,133,000</td>
</tr>
<tr>
<td>Share capital</td>
<td>NCI</td>
<td>$2,250,000</td>
</tr>
<tr>
<td>Reserves</td>
<td></td>
<td>$10,400,000</td>
</tr>
<tr>
<td>Provisions</td>
<td></td>
<td>$10,000</td>
</tr>
<tr>
<td>Property</td>
<td></td>
<td>$2,600,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$2,373,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$5,000,000</td>
</tr>
</tbody>
</table>
In this chapter we revise the construction of a consolidated statement of financial position and consolidated statement of profit or loss and other comprehensive income, taking into account issues including goodwill, fair value adjustments, intragroup items and mid-year acquisitions. Consolidated statements of cash flows are dealt with in Chapter 30.

**Topic list**

1. Consolidated statement of financial position
2. Consolidated statement of profit or loss and other comprehensive income
1 Consolidated statement of financial position

SECTION INTRODUCTION
SFRS(I) 10 prescribes the principles that are reflected in the consolidated statement of financial position.

1.1 Basic procedure
SFRS(I) 10 Consolidated Financial Statements states that the financial statements of a parent and its subsidiaries are combined on a line-by-line basis by adding together like items of assets, liabilities, equity, income and expenses.

The following steps are then taken, in order that the consolidated financial statements should show financial information about the group as if it was a single entity.

(a) The carrying amount of the parent’s investment in each subsidiary and the parent’s portion of equity of each subsidiary are eliminated or cancelled.

(b) Non-controlling interests in the net income of consolidated subsidiaries are adjusted against group income, to arrive at the net income attributable to the owners of the parent.

(c) Non-controlling interests in the net assets of consolidated subsidiaries should be presented separately in the consolidated statement of financial position.

Other matters to be dealt with include the following.

(a) Goodwill on consolidation should be dealt with according to SFRS(I) 3 Business Combinations.

(b) Dividends paid by a subsidiary

SFRS(I) 10 states that all intragroup balances and transactions (including income and expenses), and the resulting unrealised profits, should be eliminated in full. Unrealised losses resulting from intragroup transactions should also be eliminated but may indicate that some form of impairment is required. Impairments have been covered elsewhere in this manual. Elimination of intragroup transactions will be explained later in this chapter.
1.2 Elimination and part elimination

The preparation of a consolidated statement of financial position, in a very simple form, consists of two procedures.

(a) Take the individual accounts of the parent company and each subsidiary and **cancel out items** which appear as an asset in one company and a liability in another.

(b) Add together all the uncancelled assets and liabilities throughout the group.

Items requiring elimination may include the following.

(a) The asset 'shares in subsidiary companies' which appears in the parent company's accounts will be matched with the 'share capital' in the subsidiaries' accounts.

(b) There may be **intragroup trading** within the group. For example, S Co may sell goods on credit to P Co. P Co would then be a receivable in the accounts of S Co, while S Co would be a payable in the accounts of P Co.

---

**Example**

P Co regularly sells goods to its one subsidiary company, S Co, which it has owned since S Co's incorporation. The statements of financial position of the two companies on 31 December 20X6 are given below.

**STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X6**

<table>
<thead>
<tr>
<th></th>
<th>P Co</th>
<th>S Co</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Non-current assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>35,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Investment in 40,000 shares in S Co at cost</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>75,000</td>
<td>66,000</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>16,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Receivables:</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>S Co</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>6,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Cash at bank</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>100,000</td>
<td>66,000</td>
</tr>
</tbody>
</table>

| **Equity and liabilities** |       |       |
| **Equity**                |       |       |
| Ordinary shares (40,000 shares) |       | 40,000 |
| Ordinary shares (70,000 shares) | 70,000 |       |
| Retained earnings         | 16,000| 19,000|
| **Total equity**          | 86,000| 59,000|

| **Current liabilities**  |       |       |
| Bank overdraft           |       | 3,000 |
| Payables: P Co           |       | 2,000 |
| Payables: Other          | 14,000|       |
| **Total equity and liabilities** | 100,000| 66,000|

**Required**

Prepare the consolidated statement of financial position of P Co at 31 December 20X6.
Solution

The cancelling items are:

(a) P Co’s asset ‘investment in shares of S Co’ ($40,000) cancels with S Co’s issued ‘share capital’ ($40,000).

Consolidation adjustment journal

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Share capital</td>
<td>40,000</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Investment</td>
<td>40,000</td>
</tr>
</tbody>
</table>

to cancel the investment in S against the share capital of S

No goodwill arises because S has been owned since incorporation.

(b) P Co’s asset ‘receivables: S Co’ ($2,000) cancels with S Co’s liability ‘payables: P Co’ ($2,000).

Consolidation adjustment journal

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Payables</td>
<td>2,000</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Receivables</td>
<td>2,000</td>
</tr>
</tbody>
</table>

to cancel the intragroup balances

The remaining assets and liabilities are added together to produce the following consolidated statement of financial position.

P CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X6

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>28,000</td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td>Cash at bank</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td>44,000</td>
<td></td>
</tr>
<tr>
<td>Equity and liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary shares (70,000 shares)</td>
<td>70,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>35,000</td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank overdraft</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Payables</td>
<td>16,000</td>
<td></td>
</tr>
<tr>
<td>Total equity and liabilities</td>
<td>19,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>124,000</td>
<td></td>
</tr>
</tbody>
</table>

Notes:

1. P Co’s bank balance is not netted off with S Co’s bank overdraft. To offset one against the other would be less informative and would conflict with the principle that separate assets and liabilities should not be netted off. If financial assets and liabilities are to be offset they must meet the criteria in SFRS(I) 1-32 and this is unlikely to be the case as the right to offset must exist in all circumstances.
2 The share capital in the consolidated statement of financial position is the **share capital of the parent company alone**. This must be the case, no matter how complex the consolidation, because the share capital of subsidiary companies must be a wholly cancelling item. (The only exception to this is the special case of a reverse acquisition.)

Although this is a relatively simple example, you may find that a consolidation schedule working is useful as questions become more complex. In this, the statements of financial position of a parent and its subsidiaries are listed side by side and consolidation adjustment journal entries are made in a series of columns. Adding crossways will result in the consolidated statement of financial position.

Here is the previous example shown on a consolidation schedule:

<table>
<thead>
<tr>
<th></th>
<th>P Co</th>
<th>S Co</th>
<th>(a) $'000</th>
<th>(b) $'000</th>
<th>Consolidated $'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>PPE</td>
<td>35</td>
<td>45</td>
<td></td>
<td></td>
<td>80</td>
</tr>
<tr>
<td>Investment</td>
<td>40</td>
<td>12</td>
<td>(40)</td>
<td></td>
<td>28</td>
</tr>
</tbody>
</table>
| Receivables:
  | S Co  | 2    |   –     |   (2)    |       | –                 |
  | Other | 6    | 9      |          |          | 15                |
| Cash     | 1    | –    |          |          | 124               |
| Share capital | 70   | 40   |    (40)  |          | 70                |
| Retained earnings | 16   | 19   |          |          | 35                |
| Payables:
  | P Co  | 2    |   –     |   (2)    |       | 16                |
  | Other | 14   | 2      |          |          | 124               |

This is by no means the only way of showing consolidation workings, and in this chapter we shall see other types of working so that you can become used to most variations that you might see.

### 1.2.1 Part elimination

An item may appear in the statements of financial position of a parent company and its subsidiary, but not at the same amounts.

(a) The parent company may have acquired **shares in the subsidiary** at a price **greater or less than their aggregated fair value of all the identifiable assets and liabilities of the subsidiary**. This raises the issue of **goodwill**, which is dealt with later in this chapter.

(b) Even if the parent company acquired shares at book value, it **may not have acquired all the shares of the subsidiary**. This raises the issue of **non-controlling interests**, which are also dealt with later in this chapter.

(c) The inter-company trading balances may be out of step because of **goods or cash in transit**.

(d) One company may have **issued loan stock** of which a **proportion only** is taken up by the other company.

(e) Foreign exchange issues.

The following question illustrates the techniques needed to deal with items (c) and (d) above.
The statements of financial position of P Co and of its subsidiary S Co have been made up to 30 June. P Co has owned all the ordinary shares and 40% of the loan stock of S Co since its incorporation.

### Statement of Financial Position as at 30 June

<table>
<thead>
<tr>
<th></th>
<th>P Co</th>
<th>S Co</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Non-current assets</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>120,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Investment in S Co, at cost – 80,000 ordinary shares</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>$20,000 of 12% loan stock in S Co</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>220,000</td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Inventories</td>
<td>50,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>40,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Amount due from S Co</td>
<td>18,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>4,000</td>
<td>6,000</td>
</tr>
<tr>
<td></td>
<td>112,000</td>
<td>96,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>332,000</td>
<td>196,000</td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>100,000</td>
<td>80,000</td>
</tr>
<tr>
<td>(100,000 shares in P Co, 80,000 shares in S Co)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>95,000</td>
<td>28,000</td>
</tr>
<tr>
<td></td>
<td>195,000</td>
<td>108,000</td>
</tr>
<tr>
<td><strong>Non-current liabilities</strong></td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>10% loan stock</td>
<td>75,000</td>
<td></td>
</tr>
<tr>
<td>12% loan stock</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td><strong>Current liabilities</strong></td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Payables</td>
<td>47,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Taxation</td>
<td>15,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Amount due to P Co</td>
<td>12,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>62,000</td>
<td>38,000</td>
</tr>
<tr>
<td><strong>Total equity and liabilities</strong></td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td></td>
<td>332,000</td>
<td>196,000</td>
</tr>
</tbody>
</table>

The difference on current account arises because of goods in transit sold at cost.

**Required**

Prepare the consolidated statement of financial position of P Co as at 30 June.

### 1.3 Non-controlling interest

The total assets and liabilities of subsidiary companies are included in the consolidated statement of financial position, even in the case of subsidiaries which are only partly owned.

In this case, the non-controlling interest (NCI) in net assets is included in the consolidated statement of financial position as part of equity of the consolidated group. NCI is presented separately from the parent’s interest.

As we saw in the last chapter, the NCI is calculated at acquisition either at fair value or as a proportion of net assets. It subsequently increases by the NCI share of post-acquisition profits and other comprehensive income.

The following example shows the non-controlling interest calculated at its proportionate share of the subsidiary’s net assets.
Example

P Co has owned 75% of the share capital of S Co since the date of S Co's incorporation. Their latest statements of financial position are given below.

**STATEMENT OF FINANCIAL POSITION**

<table>
<thead>
<tr>
<th></th>
<th>P Co</th>
<th>S Co</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>Non-current assets</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>50,000</td>
<td>35,000</td>
</tr>
<tr>
<td>30,000 ordinary shares in S Co at cost</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>125,000</td>
<td>70,000</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td>45,000</td>
<td>35,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>125,000</td>
<td>70,000</td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary shares (80,000 shares in P Co, 40,000 shares in S Co)</td>
<td>80,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>25,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total equity and liabilities</strong></td>
<td>125,000</td>
<td>70,000</td>
</tr>
</tbody>
</table>

It is group policy to measure non-controlling interest at its proportionate share of net assets.

**Required**

Prepare the consolidated statement of financial position.

**Solution**

No goodwill arises because S Co has been owned since incorporation. All of S Co's net assets are consolidated despite the fact that the company is only 75% owned. The amount of net assets attributable to non-controlling interests is calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-controlling interest's share of share capital (25% × $40,000)</td>
<td>10,000</td>
</tr>
<tr>
<td>Non-controlling interest's share of retained earnings (25% × $10,000)</td>
<td>2,500</td>
</tr>
</tbody>
</table>

Of S Co's share capital of $40,000, $10,000 is included in the figure for non-controlling interest, while $30,000 is cancelled with P Co's asset 'Investment in S Co':

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT Share capital</td>
<td>40,000</td>
</tr>
<tr>
<td>CREDIT Investment in S</td>
<td>30,000</td>
</tr>
<tr>
<td>CREDIT NCI</td>
<td>10,000</td>
</tr>
</tbody>
</table>

To eliminate the initial investment in $ on consolidation

The NCI share of post-acquisition profits must then be allocated to them:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT Retained earnings (25% × 10)</td>
<td>2,500</td>
</tr>
<tr>
<td>CREDIT NCI</td>
<td>2,500</td>
</tr>
</tbody>
</table>

To allocate the NCI's share of post-acquisition profits
The consolidated statement of financial position can now be prepared – again we use a consolidation schedule here:

<table>
<thead>
<tr>
<th></th>
<th>P Co</th>
<th>S Co</th>
<th>Adjustment 1</th>
<th>Adjustment 2</th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>50</td>
<td>35</td>
<td>(30)</td>
<td></td>
<td>85</td>
</tr>
<tr>
<td>Investment</td>
<td>30</td>
<td>-30</td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Current assets</td>
<td>45</td>
<td>35</td>
<td>(30)</td>
<td></td>
<td>80</td>
</tr>
</tbody>
</table>

| Share capital            | 80   | 40   | (40)         |              | 80    |
| Retained earnings        | 25   | 10   |              | (2.5)        | 32.5  |
| NCI                      | 10   | 2.5  |              | 12.5         | 12.5  |
| Current liabilities      | 20   | 20   |              |              | 40    |

P GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>85,000</td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>165,000</td>
<td></td>
</tr>
</tbody>
</table>

**Equity and liabilities**

| Equity attributable to owners of the parent | 80,000 |
| Share capital                              | 80,000 |
| Retained earnings                          | 32,500 |
| **Total equity and liabilities**           | 112,500|
| Non-controlling interest                   | 12,500 |
| Current liabilities                        | 40,000 |
| **Total equity and liabilities**           | 125,000|

Although we used a consolidation schedule in this example, an alternative approach is as follows:

(a) **Aggregate** the assets and liabilities in the statement of financial position ie 100% P + 100% S irrespective of how much P actually owns.

This shows the amount of net assets **controlled** by the group.

(b) **Share capital** is that of the parent only.

(c) **Calculate** the group retained earnings as P’s retained earnings plus the group share of S’s post-acquisition retained earnings ie $25,000 + (75% \times $10,000) = $32,500.

(d) **Calculate** the non-controlling interest share of the subsidiary’s net assets (share capital plus share of retained earnings).
1.4 Dividends paid by a subsidiary

When a subsidiary company pays a dividend during the year the accounting treatment is not difficult. Suppose S Co, a 60% subsidiary of P Co, pays a dividend of $1,000 on the last day of its accounting period. Its retained profit for the year before paying the dividend stood at $5,000.

The accounting entry in respect of the dividend in S Co's accounts is:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Retained earnings</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Cash</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

The accounting entry in P's accounts is:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Cash (60% × $1,000)</th>
<th>$600</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Dividend income (SPLOCI)</td>
<td>$600</td>
</tr>
</tbody>
</table>

The entries required on consolidation are therefore:

(i) Allocate the NCI share of S Co's retained profit:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Retained earnings (40% × $5,000)</th>
<th>$2,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>NCI in net assets</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

To allocate 40% of retained profit for the year to the NCI.

(ii) Eliminate the dividend paid by S Co:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Dividend income in profit or loss (60% × $1,000)</th>
<th>$600</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>NCI (40% × $1,000)</th>
<th>$400</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Retained earnings</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

To eliminate the dividend paid by S Co against the NCI and income recognised by P Co.

Note that in the consolidated statement of financial position the debit entry against dividend income is accumulated in retained earnings. Therefore the net entry to retained earnings as a result of this journal is a credit of $400.

<table>
<thead>
<tr>
<th>P Co</th>
<th>S Co</th>
<th>(i)</th>
<th>(ii)</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$'000</td>
</tr>
<tr>
<td>PPE</td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Investment</td>
<td>X</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Inventories</td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Receivables</td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Cash</td>
<td>X</td>
<td>–</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>X</td>
<td>X</td>
<td>(2,000)</td>
<td>400</td>
</tr>
<tr>
<td>NCI</td>
<td></td>
<td>2,000</td>
<td></td>
<td>(400)</td>
</tr>
<tr>
<td>Overdraft</td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Payables</td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

Therefore in the consolidated financial statements, the net effect is:

- The group cash balance is credited with a net $400 (S's $1,000 credit entry net of P's $600 debit entry).
- Group retained earnings includes $3,000, being the group share of S Co's retained earnings for the year before payment of the dividend.
The NCI is allocated its profits for the year net of the dividend it has been paid:

| NCI profits for the year ($5,000 × 40%) | $2,000 |
| NCI dividend for the year ($1,000 × 40%) | ($400) |
| **Total** | **$1,600** |

1.5 Goodwill arising on consolidation

We have already seen how goodwill is calculated in the last chapter. Now we shall consider the accounting entries which result in goodwill appearing in the consolidated statement of financial position.

Suppose P Co purchases all of the share capital of S Co and pays $60,000 cash to the previous shareholders in consideration. The entries in P Co's individual books would be:

- **Debit:** Investment in S Co at cost 60,000
- **Credit:** Bank 60,000

Let's assume that the fair value of the identifiable net assets of S Co on the acquisition date is $52,000, represented by $20,000 share capital and $32,000 retained earnings. Therefore goodwill arises on the acquisition of $8,000.

The journal in the consolidated worksheet to record this is:

- **Debit:** Goodwill 8,000
- **Debit:** Share capital 20,000
- **Debit:** Retained earnings 32,000
- **Credit:** Investment in S  60,000

This consolidation adjustment journal may be referred to as a 'standing journal' as it is made at each period end.

The effect of each of these entries is to:

(a) Recognise the goodwill of $8,000 arising as a result of a business combination
(b) Eliminate S's share capital of $20,000
(c) Eliminate S's pre-acquisition reserves of $32,000 as these do not 'belong' to the group
(d) Eliminate the investment in S in P's books of $60,000

The subsidiary may also have share premium or revaluation surplus balances at the acquisition date. These will feature in the calculation of goodwill and be cancelled against the investment in P's books in the same way as pre-acquisition retained earnings.

Note: Singapore companies do not have share premium accounts but a foreign subsidiary might.
Example

Sing Co acquired the ordinary shares of Wing Co on 31 March when the statements of financial position of each company were as follows.

**SING CO**

**STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
</tr>
<tr>
<td>Investment in 50,000 shares of Wing Co at cost</td>
<td>80,000</td>
</tr>
<tr>
<td>Current assets</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>120,000</strong></td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>Ordinary shares</td>
<td>75,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>45,000</td>
</tr>
<tr>
<td><strong>Total equity and liabilities</strong></td>
<td><strong>120,000</strong></td>
</tr>
</tbody>
</table>

**WING CO**

**STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>60,000</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital (50,000 shares)</td>
<td>50,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>60,000</strong></td>
</tr>
</tbody>
</table>

Prepare the consolidated statement of financial position as at 31 March.

**Solution**

The technique to adopt here is to produce a new working: ‘Goodwill’. A proforma working is set out below.

**Goodwill**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Net assets acquired as represented by:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Share premium</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Retained earnings on acquisition</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
<td></td>
<td>(X)</td>
</tr>
</tbody>
</table>

Applying this to our example the working will look like this.

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>Net assets acquired as represented by:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>50,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Retained earnings on acquisition</td>
<td></td>
<td>(60,000)</td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
<td></td>
<td>20,000</td>
</tr>
</tbody>
</table>
Consolidation adjustment journal

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Goodwill</td>
<td>20,000</td>
</tr>
<tr>
<td>DEBIT</td>
<td>Share capital</td>
<td>50,000</td>
</tr>
<tr>
<td>DEBIT</td>
<td>Retained earnings</td>
<td>10,000</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Investment in Wing</td>
<td>80,000</td>
</tr>
</tbody>
</table>

SING CO

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
</tr>
<tr>
<td>Goodwill arising on consolidation (W)</td>
<td>20,000</td>
</tr>
<tr>
<td>Current assets (40,000 + 60,000)</td>
<td>100,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>120,000</td>
</tr>
<tr>
<td>Equity and liabilities</td>
<td></td>
</tr>
<tr>
<td>Ordinary shares</td>
<td>75,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>45,000</td>
</tr>
<tr>
<td>Total equity and liabilities</td>
<td>120,000</td>
</tr>
</tbody>
</table>

1.5.1 Non-controlling interest and goodwill

As we have seen, SFRS(I) 3 Business Combinations gives entities the option of measuring non-controlling interest (NCI) at fair value. Where this is the case, NCI goodwill, if any must be accounted for.

Continuing our example above, we will assume that the market price of Wing Co shares was $1.25 and Sing bought 80% of Wing for $70,000. The goodwill calculation will then be as follows:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>70,000</td>
</tr>
<tr>
<td>Fair value of NCI (20% × 50,000 × $1.25)</td>
<td>12,500</td>
</tr>
<tr>
<td>Net assets at acquisition</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>22,500</td>
</tr>
</tbody>
</table>

This goodwill can be split into:

- $22,000 ($70,000 – (80% × $60,000)) attributable to the parent; and
- $500 ($12,500 – (20% × $60,000)) attributable to the NCI.

The NCI at a given reporting date is calculated as:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>NCI at acquisition</td>
<td>X</td>
</tr>
<tr>
<td>NCI share of post-acquisition total comprehensive income</td>
<td>X</td>
</tr>
</tbody>
</table>

Where NCI is measured at fair value at acquisition, goodwill attributable to NCI is included as part of the ‘Goodwill’ recognised and a single balance for goodwill is shown in the consolidated statement of financial position. On the other hand, where NCI is measured at proportionate share of identified net assets, the amount of goodwill recognised does not include any NCI share.
**Example**

P acquired 75% of the shares in S on 1 January 20X7 when S had retained earnings of $15,000. The market price of S's shares just before the date of acquisition was $1.60. P values the non-controlling interest at fair value. Goodwill is not impaired.

The statements of financial position of P and S at 31 December 20X7 were as follows:

<table>
<thead>
<tr>
<th></th>
<th>P</th>
<th>S</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>60,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Shares in S</td>
<td>68,000</td>
<td>–</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>128,000</strong></td>
<td><strong>50,000</strong></td>
</tr>
<tr>
<td>Current assets</td>
<td>52,000</td>
<td>35,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>180,000</strong></td>
<td><strong>85,000</strong></td>
</tr>
<tr>
<td>Share capital (100,000 shares in P, 50,000 shares in S)</td>
<td>100,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>70,000</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>170,000</strong></td>
<td><strong>75,000</strong></td>
</tr>
<tr>
<td>Current liabilities</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>180,000</strong></td>
<td><strong>85,000</strong></td>
</tr>
</tbody>
</table>

Prepare the consolidated statement of financial position of the P Group as at 31 December 20X7.

**Solution**

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X7**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment (60 + 50)</td>
<td>110,000</td>
</tr>
<tr>
<td>Goodwill (W1)</td>
<td>23,000</td>
</tr>
<tr>
<td>Current assets (52 + 35)</td>
<td>87,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>220,000</strong></td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Equity attributable to the owners of P</td>
<td></td>
</tr>
<tr>
<td>Share capital (100 + 50 – 50)</td>
<td>100,000</td>
</tr>
<tr>
<td>Retained earnings (70 + 25 – 15 – 2.5)</td>
<td>77,500</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td><strong>177,500</strong></td>
</tr>
<tr>
<td>Non-controlling interest (20 + 2.5)</td>
<td>22,500</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td><strong>220,000</strong></td>
</tr>
</tbody>
</table>

**Workings**

1. **Goodwill**

<table>
<thead>
<tr>
<th></th>
<th>Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td></td>
</tr>
<tr>
<td>Consideration transferred</td>
<td>68,000</td>
</tr>
<tr>
<td>Fair value of NCI (12,500* × $1.60)</td>
<td>20,000</td>
</tr>
<tr>
<td>Net assets of S at acquisition (50,000 + 15,000)</td>
<td>(65,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>23,000</td>
</tr>
</tbody>
</table>

* 50,000 × 25%
Consolidation adjustment journal

<table>
<thead>
<tr>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Goodwill</td>
</tr>
<tr>
<td>DEBIT</td>
<td>Share capital</td>
</tr>
<tr>
<td>DEBIT</td>
<td>Retained earnings</td>
</tr>
<tr>
<td>CREDIT</td>
<td>NCI</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Investment</td>
</tr>
</tbody>
</table>

To record the initial goodwill and NCI on acquisition. This entry is commonly known as a permanent adjustment entry. It will remain the same unless there is an adjustment to the fair values of the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of the combination as mentioned in Chapter 24 Section 3.10.

2 Consolidated retained earnings and NCI

<table>
<thead>
<tr>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per statement of financial position</td>
</tr>
<tr>
<td>Less pre-acquisition</td>
</tr>
<tr>
<td>Therefore group retained earnings is:</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings of P</td>
</tr>
<tr>
<td>Group share of S's retained earnings (75% × 10,000)</td>
</tr>
<tr>
<td>Therefore group retained earnings is:</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>NCI at acquisition</td>
</tr>
<tr>
<td>NCI share of S's retained earnings (25% × $10,000)</td>
</tr>
<tr>
<td>Therefore group NCI is:</td>
</tr>
</tbody>
</table>

This is achieved on consolidation by:

Consolidation adjustment journal

<table>
<thead>
<tr>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Retained earnings</td>
</tr>
<tr>
<td>CREDIT</td>
<td>NCI</td>
</tr>
</tbody>
</table>

1.5.2 Impairment of goodwill

Goodwill arising on consolidation is subjected to an annual impairment review in accordance with SFRS(I) 1-36 Impairment of Assets. Impairment may be expressed as an amount or as a percentage. The double entry to write off the goodwill impaired is:

DEBIT | Group retained earnings (through Profit and Loss) |
CREDIT | Goodwill |

However, when non-controlling interest is valued at fair value the goodwill in the statement of financial position includes goodwill attributable to the non-controlling interest. In this case the double entry will reflect the non-controlling interest proportion based on their shareholding as follows:

DEBIT | Group retained earnings (through Profit and Loss) |
DEBIT | Non-controlling interest |
CREDIT | Goodwill |
In our solution above for P and S the non-controlling interest holds 25%. If the total goodwill of $23,000 was impaired by 20% the double entry for this would be:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Group retained earnings (through profit or loss) (75%)</td>
<td>3,450</td>
</tr>
<tr>
<td>DEBIT</td>
<td>Non-controlling interest (25%)</td>
<td>1,150</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Goodwill</td>
<td>4,600</td>
</tr>
</tbody>
</table>

The non-controlling interest at the year-end would then be $21,350 ($22,500 as reported in the consolidated SOFP in the example above – $1,150 impairment loss).

### 1.5.3 Gain on a bargain purchase

As explained in Chapter 24, the aggregate of the fair values of the separable net assets acquired may exceed what the parent company paid for them. This is sometimes referred to as negative goodwill. SFRS(I) 3 refers to it as a ‘gain on a bargain purchase’. In this situation:

(a) An entity should first reassess whether it has identified all assets acquired and liabilities assumed and recognise any that were not originally identified. The entity should also review the procedures used to measure the amounts required to be recognised on acquisition date. The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

(b) Any excess remaining should be recognised immediately in profit or loss in accordance with SFRS(I) 3 Business Combinations.

### Question 25.2

**Consolidated statement of financial position**

The statements of financial position of Ping Co and Pong Co on 30 June 20X8 were as follows.

**STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X8**

<table>
<thead>
<tr>
<th></th>
<th>Ping Co $</th>
<th>Pong Co $</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>50,000</td>
<td>40,000</td>
</tr>
<tr>
<td>20,000 ordinary shares in Pong Co at cost</td>
<td>38,734</td>
<td>88,734</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>3,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Owed by Ping Co</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>16,000</td>
<td>7,000</td>
</tr>
<tr>
<td>Cash</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>109,734</td>
<td>65,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Ping Co $</th>
<th>Pong Co $</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital (45,000 shares in Ping Co, 25,000 shares in Pong Co)</td>
<td>45,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Revaluation surplus</td>
<td>12,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>25,388</td>
<td>28,000</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td>82,388</td>
<td>58,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Ping Co $</th>
<th>Pong Co $</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred consideration</td>
<td>9,346</td>
<td></td>
</tr>
<tr>
<td>Owed to Pong Co</td>
<td>8,000</td>
<td></td>
</tr>
<tr>
<td>Trade payables</td>
<td>10,000</td>
<td>7,000</td>
</tr>
<tr>
<td><strong>Total equity and liabilities</strong></td>
<td>109,734</td>
<td>65,000</td>
</tr>
</tbody>
</table>

SFRS(I) 3 paras 34–36
Ping Co acquired its investment in Pong Co on 1 July 20X7 when the retained earnings of Pong Co stood at $6,000. The agreed consideration was $30,000 cash and a further $10,000 on 1 July 20X9. Ping Co’s cost of capital is 7%. Pong Co has an indefinite life internally-developed brand name – ‘Pongo’ – which was valued at $5,000 at the date of acquisition. There have been no changes in the share capital or revaluation surplus of Pong Co since that date. At 30 June 20X8 Pong Co had invoiced Ping Co for goods, sold at cost, to the value of $2,000 and Ping Co had sent payment in full but this had not been received by Pong Co.

There is no impairment of goodwill. It is group policy to measure non-controlling interest at fair value. At the acquisition date the non-controlling interest was valued at $9,000.

Prepare the consolidated statement of financial position of Ping Co as at 30 June 20X8.

1.6 Intragroup trading and unrealised profit

Any receivable/payable balances outstanding between group companies are eliminated on consolidation. No further problem arises if all such intragroup transactions are undertaken at cost, without any mark-up for profit.

However, each company in a group is a separate trading entity and may wish to treat other group companies in the same way as any other customer. In this case, a company (say A Co) may buy goods at one price and sell them at a higher price to another group company (B Co). The accounts of A Co will quite properly include the profit earned on sales to B Co; and similarly B Co’s statement of financial position will include inventories at their cost to B Co, ie at the amount at which they were purchased from A Co.

This gives rise to two problems.

(a) Although A Co makes a profit as soon as it sells goods to B Co, the group does not make a sale or achieve a profit until an outside customer buys the goods from B Co.

(b) Any inventory purchases from A Co which remain unsold by B Co at the year-end will be included in B Co’s inventory. The inventory value in the statement of financial position will be the cost to B Co, which is not the same as the initial cost to the group.

The objective of consolidated accounts is to present the financial position of several connected entities as though they are a single entity, the group. This means that in a consolidated statement of financial position the only profits recognised should be those earned by the group in providing goods or services to outsiders; and similarly, inventory in the consolidated statement of financial position should be valued at cost to the group.

Suppose that a parent company P Co buys goods for $1,600 and sells them to a wholly owned subsidiary S Co for $2,000. The goods are in S Co’s inventory at the year-end and appear in S Co’s statement of financial position at $2,000. In this case, P Co will record a profit of $400 in its individual accounts, but from the group’s point of view the figures are:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>1,600</td>
</tr>
<tr>
<td>External sales</td>
<td>nil</td>
</tr>
<tr>
<td>Closing inventory at cost</td>
<td>1,600</td>
</tr>
<tr>
<td>Profit/loss</td>
<td>nil</td>
</tr>
</tbody>
</table>

If we add together the figures for retained earnings and inventory in the individual statements of financial position of P Co and S Co the resulting figures for consolidated retained earnings and consolidated inventory will each be overstated by $400. A consolidation adjustment is therefore necessary as follows:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Group retained earnings (through profit or loss)</td>
<td>$400</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Group inventory (statement of financial position)</td>
<td>$400</td>
</tr>
</tbody>
</table>

with the amount of profit unrealised by the group.
In this example the parent company is the selling company and therefore adjustment is made to the parent company's profits and retained earnings.

Where a subsidiary company is the selling company (selling to the parent or to another subsidiary), the unrealised profit adjustment is made to the subsidiary' profit (and retained earnings).

1.6.1 Non-controlling interests in unrealised intragroup profits

A further problem occurs where a subsidiary company which is not wholly owned is involved in intragroup trading within the group. If a subsidiary S Co is 75% owned and sells goods to the parent company for $16,000 cost plus $4,000 profit, ie for $20,000 and if these items are unsold by P Co at the end of the reporting period, the 'unrealised' profit of $4,000 earned by S Co and charged to P Co will be partly owned by the non-controlling interest of S Co.

Where a subsidiary company with an NCI is the seller, the correct treatment of an intragroup unrealised profits is to remove the whole profit, charging the non-controlling interest with their proportion.

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Group retained earnings (through profit or loss)</th>
<th>$3,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Non-controlling interest (through profit or loss)</td>
<td>$1,000</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Group inventory (statement of financial position)</td>
<td>$4,000</td>
</tr>
</tbody>
</table>

**Example**

P Co has owned 75% of the shares of S Co since the incorporation of that company. During the year to 31 December 20X2, S Co sold goods costing $16,000 to P Co at a price of $20,000 and these goods were still unsold by P Co at the end of the year. Statements of financial position of each company at 31 December 20X2 were as follows.

<table>
<thead>
<tr>
<th></th>
<th>P Co</th>
<th>S Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>125,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Investment: 75,000 shares in S Co at cost</td>
<td>75,000</td>
<td>-</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>50,000</td>
<td>48,000</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>20,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>270,000</td>
<td>184,000</td>
</tr>
<tr>
<td>Equity and liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital (80,000 shares in P Co, 100,000 shares in S Co)</td>
<td>80,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>150,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>230,000</td>
<td>160,000</td>
</tr>
<tr>
<td>Total equity and liabilities</td>
<td>270,000</td>
<td>184,000</td>
</tr>
</tbody>
</table>

**Required**

Prepare the consolidated statement of financial position of P Co at 31 December 20X2. The fair value of the non-controlling interest at acquisition (measured under either method as it was acquired at incorporation) was $25,000.
Solution

The profit earned by S Co but unrealised by the group is $4,000. After elimination of the unrealised profit, S Co’s profit is $56,000 ($60,000 – $4,000).

<table>
<thead>
<tr>
<th>Workings</th>
<th>P Co</th>
<th>S Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per question</td>
<td>150,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Less unrealised profit</td>
<td>(4,000)</td>
<td></td>
</tr>
<tr>
<td>Share of S Co: $56,000 × 75%</td>
<td>42,000</td>
<td>56,000</td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fair value at acquisition</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Share of post-acquisition retained earnings (56,000 × 25%)</td>
<td>14,000</td>
<td>39,000</td>
</tr>
</tbody>
</table>

As the workings illustrate, 75% of the unrealised profit (so $3,000) is attributable to the group and reduces group retained earnings and 25% ($1,000) is attributable to the NCI and reduces the NCI in net assets.

P CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2

<table>
<thead>
<tr>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment (125,000 + 120,000)</td>
<td>245,000</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
</tr>
<tr>
<td>Inventories (50,000 + 48,000 – 4,000)</td>
<td>94,000</td>
</tr>
<tr>
<td>Trade receivables (20,000 + 16,000)</td>
<td>36,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>130,000</td>
</tr>
<tr>
<td>Equity and liabilities</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital (P only)</td>
<td>80,000</td>
</tr>
<tr>
<td>Retained earnings (working)</td>
<td>192,000</td>
</tr>
<tr>
<td>Non-controlling interest (working)</td>
<td>39,000</td>
</tr>
<tr>
<td>Current liabilities (40,000 + 24,000)</td>
<td>64,000</td>
</tr>
<tr>
<td>Total equity and liabilities</td>
<td>375,000</td>
</tr>
</tbody>
</table>

This example shows how a consolidation may be performed without considering consolidation adjustment journals and producing a consolidation schedule. Here assets and liabilities are totalled in brackets on the face of the statement of financial position, with any adjustments made here. Workings are then produced separately for retained earnings, the NCI and goodwill (although in this case there is no goodwill as S Co was not purchased).

Try this approach in the following question.
Question 25.3

P Co acquired 80% of the shares in S Co one year ago when the retained earnings of S Co stood at $10,000. Statements of financial position for each company are as follows.

<table>
<thead>
<tr>
<th></th>
<th>P Co</th>
<th>$</th>
<th>S Co</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>80,000</td>
<td></td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Investment in S Co at cost</td>
<td>46,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>126,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>40,000</td>
<td></td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>166,000</td>
<td></td>
<td>70,000</td>
<td></td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital (100,000 shares in P Co, 30,000 shares in S Co)</td>
<td>100,000</td>
<td>30,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>45,000</td>
<td></td>
<td>22,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>145,000</td>
<td></td>
<td>52,000</td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td>21,000</td>
<td></td>
<td>18,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total equity and liabilities</strong></td>
<td>166,000</td>
<td></td>
<td>70,000</td>
<td></td>
</tr>
</tbody>
</table>

During the year S Co sold goods to P Co for $50,000, the profit to S Co being 20% of selling price. At the end of the reporting period, $15,000 of these goods remained unsold in the inventories of P Co. At the same date, P Co owed S Co $12,000 for goods bought and this debt is included in the trade payables of P Co and the receivables of S Co. The non-controlling interest is measured at fair value. It was valued at $9,000 at the date of acquisition.

**Required**

Prepare a consolidated statement of financial position for P Co.

1.7 Intragroup sales of non-current assets

In their individual accounts, the companies concerned will treat the transfer just like a sale between unconnected parties: the selling company will record a profit or loss on sale, while the purchasing company will record the asset at the amount paid to acquire it, and will use that amount as the basis for calculating depreciation/amortisation.

On consolidation, the usual 'group entity' principle applies. The consolidated statement of financial position must show assets at their cost to the group, and any depreciation charged must be based on that cost. Two consolidation adjustments will usually be needed to achieve this.

(a) An adjustment to alter retained earnings and non-current assets cost so as to remove any element of unrealised profit or loss. This is similar to the adjustment required in respect of unrealised profit in inventory.

(b) An adjustment to alter retained earnings and accumulated depreciation is made so that consolidated depreciation is based on the asset's cost to the group.

In practice, these steps are combined so that the retained earnings of the entity making the unrealised profit are debited with the unrealised profit less the additional depreciation.

The double entry is as follows.

(a) Sale by parent

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group retained earnings (through profit or loss)</td>
<td>Non-current assets</td>
</tr>
</tbody>
</table>

with the profit on disposal, less the additional depreciation/amortisation
(b) Sale by subsidiary

<table>
<thead>
<tr>
<th>Debit</th>
<th></th>
<th>Cred</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Group retained earnings (P's share of S)</td>
<td></td>
<td>Non-controlling interest (NCI's share of S)</td>
<td></td>
</tr>
<tr>
<td>Non-current assets with the profit on disposal, less additional depreciation/amortisation</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Example**

P Co has owned 60% of S Co since S Co's incorporation. On 1 January 20X1 S Co sells plant with a carrying amount of $10,000 to P Co for $12,500. The plant has a remaining useful life of 10 years. The companies make up accounts to 31 December 20X1 and the balances on their retained earnings at that date are:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>P Co</td>
<td>after charging depreciation on plant</td>
</tr>
<tr>
<td>S Co</td>
<td>including profit on sale of plant</td>
</tr>
</tbody>
</table>

**Required**

Calculate consolidated retained earnings as at 31 December 20X1.

**Solution**

<table>
<thead>
<tr>
<th>Retained earnings</th>
<th>P Co</th>
<th>S Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td></td>
<td>$</td>
</tr>
<tr>
<td>Per question</td>
<td>27,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Disposal of plant</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit</td>
<td>(2,500)</td>
<td></td>
</tr>
<tr>
<td>Extra depreciation: 10% × $2,500</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>Share of S Co: $15,750 × 60%</td>
<td>9,450</td>
<td></td>
</tr>
<tr>
<td></td>
<td>36,450</td>
<td></td>
</tr>
</tbody>
</table>

**Notes:**

1. The non-controlling interest in the retained earnings of S Co is 40% × $15,750 = $6,300.
2. $2,250, being the profit on the transfer less related depreciation (2,500 – 250), will be deducted from the carrying amount of the plant to write it down to cost to the group.
3. On consolidation, the depreciation adjustment is made in the accounts of the entity that made the sale (even though it is not the company depreciating the asset) as some of the profit element has now been realised. Therefore where the selling company is the subsidiary, the adjustment is allocated between the group and NCI interests.

**1.8 Mid-year acquisition**

The issue with a mid-year acquisition is establishing the reserves of the subsidiary at the acquisition date; as we have seen:

- Pre-acquisition reserves form part of the goodwill calculation and are eliminated on consolidation
- Post-acquisition reserves are allocated to the group and NCI

For example, suppose the accounts of S Co, a 60% subsidiary of P Co, show retained earnings of $20,000 at the end of the reporting period, of which $14,000 were earned prior to acquisition. The figure of $20,000 will appear in the consolidated statement of financial position as follows.
Non-controlling interests working: their share of total retained earnings
(40% \times 20,000)  
\begin{align*}
\text{8,000} \\
\end{align*} 

Goodwill working: group share of pre-acquisition retained earnings (60% \times 14,000)  
\begin{align*}
\text{8,400} \\
\end{align*} 

Consolidated retained earnings working: group share of post-acquisition retained earnings (60% \times 6,000)  
\begin{align*}
\text{3,600} \\
\text{20,000} \\
\end{align*} 

In practice, a subsidiary company’s profit may not accrue evenly over the year; for example, the subsidiary might be engaged in a trade, such as toy sales, with marked seasonal fluctuations. Nevertheless, the assumption can be made that \textbf{profits accrue evenly} whenever it is impracticable to arrive at an accurate split of pre- and post-acquisition profits. Where an entity is not publicly traded, it would be usual practice for the acquiree entity to prepare financial statements at the date of acquisition.

Once the amount of pre-acquisition profit has been established the appropriate consolidation workings (goodwill, retained earnings) can be produced.

\begin{itemize}
    \item \textbf{Question 25.4 Acquisition}
\end{itemize}

Han Loo Co acquired 80% of the ordinary shares of Ruan Seng Co on 1 April 20X5. On 31 December 20X4 Ruan Seng Co’s accounts showed retained earnings of $15,000. The statements of financial position of the two companies at 31 December 20X5 are set out below. Neither company has paid any dividends during the year. Non-controlling interest should be valued at full fair value. The market price of the subsidiary’s shares was $2.50 prior to acquisition by the parent.

You are required to prepare the consolidated statement of financial position of Han Loo Co at 31 December 20X5. There has been no impairment of goodwill.

\begin{itemize}
    \item \textbf{STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5}
\end{itemize}

\begin{center}
\begin{tabular}{lcc}
\hline
\textbf{} & \textbf{Han Loo Co} & \textbf{Ruan Seng Co} \\
\hline
\textbf{Assets} & & \\
Non-current assets & & \\
Property, plant and equipment & $32,000$ & $30,000$ \\
16,000 shares in Ruan Seng Co & $50,000$ & \\
& $82,000$ & \\
\textbf{Current assets} & $85,000$ & $43,000$ \\
\textbf{Total assets} & $167,000$ & $73,000$ \\
\hline
\textbf{Equity and liabilities} & & \\
\textbf{Equity} & & \\
Ordinary share capital (100,000 shares in Han Loo Co) & $107,000$ & \\
Ordinary share capital (20,000 shares in Ruan Seng Co) & $40,000$ & $14,000$ \\
Retained earnings & $147,000$ & $39,000$ \\
& $167,000$ & $53,000$ \\
\textbf{Current liabilities} & $20,000$ & $20,000$ \\
\textbf{Total equity and liabilities} & $167,000$ & $73,000$ \\
\hline
\end{tabular}
\end{center}
SECTION SUMMARY

A consolidated statement of financial position is prepared by:

(a) Adding assets and liabilities of the parent and subsidiary, cancelling intragroup balances and adjusting for any unrealised profits

(b) Cancelling the investment in a subsidiary against the share capital and pre-acquisition reserves acquired to calculate goodwill

(c) Recognising any non-controlling interest at the acquisition date and subsequently adjusting this by the NCI share of post-acquisition total comprehensive income.

2 Consolidated statement of profit or loss and other comprehensive income

SECTION INTRODUCTION

The consolidated statement of profit or loss and other comprehensive income is prepared using the same principles as prescribed by SFRS(I) 10 and used to prepare the consolidated statement of financial position.

The basic approach to the consolidated statement of profit or loss and other comprehensive income is to:

(a) Add together the income and expenses of parent and subsidiary
(b) Cancel any intragroup transactions, adjusting for unrealised profits
(c) Allocate profits (and total comprehensive income) between the group and non-controlling interest

It is customary in practice to prepare a working paper (known as a consolidation schedule) on which the individual statements of profit or loss are set out side by side and totalled, subject to adjustments to form the basis of the consolidated statement of profit or loss. In the following simple example, however, this is not necessary.

Example

P Co acquired 75% of the ordinary shares of S Co on that company’s incorporation in 20X3. The summarised statements of profit or loss and movement on retained earnings of the two companies for the year ending 31 December 20X6 are set out below.

<table>
<thead>
<tr>
<th></th>
<th>P Co</th>
<th>S Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>75,000</td>
<td>38,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(30,000)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>45,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>(14,000)</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>31,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(10,000)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>21,000</td>
<td>8,000</td>
</tr>
</tbody>
</table>
Note: Movement on retained earnings

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings brought forward</td>
<td>87,000</td>
<td>17,000</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>21,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Retained earnings carried forward</td>
<td>108,000</td>
<td>25,000</td>
</tr>
</tbody>
</table>

Required

Prepare the consolidated statement of profit or loss and extract from the statement of changes in equity showing retained earnings and non-controlling interest.

Solution

P CO
CONSORTIATED STATEMENT OF PROFIT OR LOSS
FOR THE YEAR ENDED 31 DECEMBER 20X6

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue (75,000 + 38,000)</td>
<td>113,000</td>
</tr>
<tr>
<td>Cost of sales (30,000 + 20,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>63,000</td>
</tr>
<tr>
<td>Administrative expenses (14,000 + 8,000)</td>
<td>(22,000)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>41,000</td>
</tr>
<tr>
<td>Income tax expense (10,000 + 2,000)</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>29,000</td>
</tr>
</tbody>
</table>

Profit attributable to:
Owners of the parent     | 27,000 |
Non-controlling interest (8,000 × 25%) | 2,000 |

STATEMENT OF CHANGES IN EQUITY (EXTRACT)

<table>
<thead>
<tr>
<th></th>
<th>Retained earnings</th>
<th>Non-controlling interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 1 January 20X6</td>
<td>(87,000 + (75% × 17,000)) (25% × 17,000)</td>
<td>99,750</td>
</tr>
<tr>
<td>Total comprehensive income for the year</td>
<td>27,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Balance at 31 December 20X6</td>
<td>126,750</td>
<td>6,250</td>
</tr>
</tbody>
</table>

Notice how the non-controlling interest is dealt with.

(a) Down to the line ‘profit for the year’ the whole of S Co’s results is included without reference to group share or non-controlling share. A one-line adjustment is then inserted to show the non-controlling share of S Co’s profit.

(b) The non-controlling interest ($4,250) in S Co’s retained earnings brought forward (17,000 × 25%) is excluded from group retained earnings. This means that the carried forward figure of $126,750 is the figure which would appear in the statement of financial position for group retained earnings.

This last point may be clearer if we construct the working for group retained earnings.

Group retained earnings at 31 December 20X6

<table>
<thead>
<tr>
<th></th>
<th>P Co</th>
<th>S Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>At year-end</td>
<td>108,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Less pre-acquisition retained earnings</td>
<td>-</td>
<td>25,000</td>
</tr>
<tr>
<td>S Co – share of post-acquisition retained earnings (25,000 × 75%)</td>
<td>18,750</td>
<td>126,750</td>
</tr>
</tbody>
</table>
The non-controlling share of S Co's retained earnings comprises the non-controlling interest in the $17,000 profits brought forward plus the non-controlling interest ($2,000) in $8,000 retained profits for the year.

We will now look at the complications introduced by intragroup trading, intragroup dividends and pre-acquisition profits in the subsidiary.

### 2.1 Intragroup trading

Like the consolidated statement of financial position, the consolidated statement of profit or loss should deal with the results of the group as those of a single entity, and consolidated figures for sales revenue and cost of sales should represent sales to, and purchases from, outsiders. An adjustment is therefore necessary to reduce the sales revenue and cost of sales figures by the value of intragroup sales during the year:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Sales revenue</th>
<th>X</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Cost of sales</td>
<td>X</td>
</tr>
</tbody>
</table>

To eliminate intragroup sale.

We have also seen in Chapter 24 that any unrealised profits on intragroup trading should be excluded from the figure for group profits. This will occur whenever goods sold at a profit within the group remain in the inventory of the purchasing company at the year-end. The best way to deal with this is to calculate the unrealised profit on unsold inventories at the year-end and increase cost of sales by this amount:

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Cost of sales</th>
<th>X</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>Inventory (CSFP)</td>
<td>X</td>
</tr>
</tbody>
</table>

To adjust for unrealised profits in inventory.

#### Example

Suppose in our earlier example that S Co had recorded sales of $5,000 to P Co during 20X6. S Co had purchased these goods from outside suppliers at a cost of $3,000. One half of the goods remained in P Co's inventory at 31 December 20X6.

(a) Prepare the revised consolidated statement of profit or loss.

(b) How would your answer have differed if P Co had sold the goods to S Co?

#### Solution

(a) The consolidated statement of profit or loss for the year ended 31 December 20X6 would now be as follows.

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue (75,000 + 38,000 – 5,000)</td>
<td>108,000</td>
</tr>
<tr>
<td>Cost of sales (30,000 + 20,000 – 5,000 + 1,000*)</td>
<td>(46,000)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>62,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>(22,000)</td>
</tr>
<tr>
<td>Profit before taxation</td>
<td>40,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>28,000</td>
</tr>
</tbody>
</table>

Profit attributable to:

| Owners of the parent | 26,250 |
| Non-controlling interest (8,000 – 1,000) × 25% | 1,750 |

| Total                     | 28,000 |
Note:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings brought forward</td>
<td>99,750</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>26,250</td>
</tr>
<tr>
<td>Retained earnings carried forward</td>
<td>126,000</td>
</tr>
</tbody>
</table>

*Unrealised profit: \( \frac{1}{2} \times (5,000 - 3,000) \) because half the goods remain in P’s inventory at the reporting date. As S Co is the selling company, the unrealised profit of $1,000 is allocated to the owners of the parent and NCI in proportion to their ownership interests.

An adjustment will be made for the unrealised profit against the inventory figure in the consolidated statement of financial position.

(b) If P Co were the selling company rather than S Co:

- Amounts reported in the statement of profit or loss to profit for the year would be unchanged; the $1,000 unrealised profit would be added to cost of sales as it is above.
- The profit for the year would be split as follows:
  - NCI: $2,000 \( (8,000 \times 25\%) \)
  - Owners of the parent therefore $26,000
- The same adjustment would be required to inventories in the statement of financial position.

### 2.2 Intragroup dividends

In our example so far we have assumed that S Co retains all of its after-tax profit. It may be, however, that S Co distributes some of its profits as dividends.

As before, the **non-controlling interest** in the subsidiary’s profit should be calculated immediately after the figure of after-tax profit. For this purpose, no account need be taken of how much of the non-controlling interest is to be distributed by S Co as dividend.

Note that group retained earnings are only adjusted for dividends paid to the parent company. Dividends paid by the subsidiary to the parent are cancelled on consolidation and dividends paid to the non-controlling interest are replaced by the allocation to the non-controlling interest of their share of the profit for the year of the subsidiary.

### 2.3 Pre-acquisition profits

If the subsidiary is **acquired during the accounting year**, it is necessary to apportion its profit for the year between pre-acquisition and post-acquisition elements. This will be done by simple time apportionment (ie assuming that profits arose evenly throughout the year) in this text for simplicity but there may be seasonal trading or other effects which imply a different split than by time apportionment. In practice, financial statements are created at acquisition to obtain the correct pre-acquisition figures.

With a mid-year acquisition, the entire statement of profit or loss of the subsidiary is split between pre-acquisition and post-acquisition amounts. Only the post-acquisition figures are included in the consolidated statement of profit or loss.

Any dividends paid out of pre-acquisition profits are, in essence, a return on equity.
Question 25.5

P Co acquired 60% of the $100,000 share capital of S Co on 1 April 20X5. The cost of investment paid by P approximates its proportionate share of the fair value of net identifiable assets assumed and NCI is valued at the non-controlling interest's proportionate share of the acquiree's identifiable assets. The statements of profit or loss of the two companies for the year ended 31 December 20X5 are set out below.

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>P Co</strong></td>
<td><strong>S Co</strong></td>
<td><strong>S Co (112)</strong></td>
<td></td>
</tr>
<tr>
<td>Sales revenue</td>
<td>170,000</td>
<td>80,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(65,000)</td>
<td>(36,000)</td>
<td>(27,000)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>105,000</td>
<td>44,000</td>
<td>33,000</td>
</tr>
<tr>
<td>Other income – dividend received from S Co</td>
<td>3,600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>(43,000)</td>
<td>(12,000)</td>
<td>(9,000)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>65,600</td>
<td>32,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(23,000)</td>
<td>(8,000)</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>42,600</td>
<td>24,000</td>
<td>18,000</td>
</tr>
</tbody>
</table>

Note:

Dividends (paid 31 December) 12,000 6,000
Profit retained 30,600 18,000
Retained earnings brought forward 81,000 40,000
Retained earnings carried forward 111,600 58,000

Required

Prepare the consolidated statement of profit or loss and the retained earnings and non-controlling interest extracts from the statement of changes in equity.

Question 25.6

The following information relates to Orchard Hospitality Co and its subsidiary Lucky Foods Co for the year ended 30 April 20X7.

<table>
<thead>
<tr>
<th></th>
<th>Orchard Hospitality Co</th>
<th>Lucky Foods Co</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$000</td>
<td>$000</td>
</tr>
<tr>
<td>Sales revenue</td>
<td>1,100</td>
<td>500</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(630)</td>
<td>(300)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>470</td>
<td>200</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>(105)</td>
<td>(150)</td>
</tr>
<tr>
<td>Dividend from Lucky Foods Co</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td>Profit before tax</td>
<td>389</td>
<td>50</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(65)</td>
<td>(10)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>324</td>
<td>40</td>
</tr>
</tbody>
</table>

Note:

Dividends paid 200 30
Profit retained 124 10
Retained earnings brought forward 460 48
Retained earnings carried forward 584 58
Notes:

(a) The issued share capital of the group was as follows.
   Orchard Hospitality Co : $5 million share capital (5,000,000 ordinary shares)
   Lucky Foods Co : $1 million share capital (1,000,000 ordinary shares)

(b) Orchard Hospitality Co purchased 80% of the issued share capital of Lucky Foods Co on 1 November 20X6. At that time, the retained earnings of Lucky Foods stood at $52,000.

(c) Non-controlling interests are recorded by the group at the fair value of the proportion of the identifiable net assets of subsidiaries.

Required

Insofar as the information permits, prepare the Orchard Hospitality Co consolidated statement of profit or loss for the year to 30 April 20X7, and extracts from the statement of changes in equity showing group retained earnings and the non-controlling interest.

2.4 Other comprehensive income

The procedure applied to items of income and expense also applies to other comprehensive income ie that of the parent and the subsidiary are added together.

Total comprehensive income is then allocated between the owners of the parent and NCI.

Example

The consolidated statement of profit or loss of the Orchard Hospitality Group is as in the answer to the last question. In addition, Lucky Foods made a $200,000 revaluation gain on its only property (accounted for under SFRS(I) 1-16) during the year, the gain all arising in the post-acquisition period.

Solution

ORCHARD HOSPITALITY GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR TO 30 APRIL 20X7

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>1,350</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(780)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>570</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>(180)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>390</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(70)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>320</td>
</tr>
<tr>
<td>Other comprehensive income:</td>
<td></td>
</tr>
<tr>
<td>Gain on property revaluation</td>
<td>200</td>
</tr>
<tr>
<td>Total comprehensive income for the year</td>
<td>520</td>
</tr>
<tr>
<td>Profit attributable to:</td>
<td></td>
</tr>
<tr>
<td>Owners of the parent</td>
<td>316</td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>4</td>
</tr>
<tr>
<td>Total comprehensive income</td>
<td></td>
</tr>
<tr>
<td>attributable to:</td>
<td></td>
</tr>
<tr>
<td>Owners of the parent (316 + (200 × 80%))</td>
<td>476</td>
</tr>
<tr>
<td>Non-controlling interest (4 + (200 × 20%))</td>
<td>44</td>
</tr>
<tr>
<td></td>
<td>520</td>
</tr>
</tbody>
</table>
2.5 Full worked example

Example

On 1 July 20X8 Crystal acquired 60,000 of the 100,000 shares in Pebble, its only subsidiary. The statements of profit or loss and other comprehensive income of both companies for the year ended 31 December 20X8 are shown below:

<table>
<thead>
<tr>
<th></th>
<th>Crystal</th>
<th>Pebble</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Revenue</td>
<td>43,000</td>
<td>26,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(28,000)</td>
<td>(18,000)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>15,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Other income – dividend received from Pebble</td>
<td>2,000</td>
<td>–</td>
</tr>
<tr>
<td>Distribution costs</td>
<td>(2,000)</td>
<td>(800)</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>(4,000)</td>
<td>(2,200)</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(500)</td>
<td>(300)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>10,500</td>
<td>4,700</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(1,400)</td>
<td>(900)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>9,100</td>
<td>3,800</td>
</tr>
<tr>
<td>Other comprehensive income:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain on property revaluation (Note (i))</td>
<td>–</td>
<td>3,000</td>
</tr>
<tr>
<td>Gain on investment in equity instrument</td>
<td>200</td>
<td>–</td>
</tr>
<tr>
<td>Total comprehensive income for the year</td>
<td>9,300</td>
<td>6,800</td>
</tr>
</tbody>
</table>

Notes:

(a) At the date of acquisition the fair values of Pebble’s assets were equal to their carrying amounts with the exception of a building which was estimated to have a fair value of $1 million in excess of its carrying amount. Even though the policy of Pebble is to record its buildings at revalued amounts it did not record this increase in value at the half year stage as this was half way through the year. At 1 July 20X8, the building had a remaining useful life of 20 years. Building depreciation is charged to administrative expenses. The building was revalued formally at 31 December 20X8 and its fair value had increased by an additional $2 million since acquisition. Depreciation for 20X8 was based on the previous year-end revalued amount.

(b) Sales from Crystal to Pebble were $6 million during the post-acquisition period. Crystal marks up all sales by 20%. At the year-end, the entire stock was still held by Pebble.

(c) Despite the property revaluation, Crystal has concluded that goodwill in Pebble has been impaired by $500,000.

(d) It is Crystal’s policy to value the non-controlling interest at full (fair) value.

(e) Income and expenses can be assumed to have arisen evenly throughout the year.

Required

Prepare the consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X8.
Solution

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue (43,000 + (26,000 × 6/12) – 6,000 (W1))</td>
<td>50,000</td>
</tr>
<tr>
<td>Cost of sales (28,000 + (18,000 × 6/12) – 6,000 + 1,000 (W1))</td>
<td>(32,000)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>18,000</td>
</tr>
<tr>
<td>Distribution costs (2,000 + (800 × 6/12))</td>
<td>(2,400)</td>
</tr>
<tr>
<td>Administrative expenses (4,000 + (2,200 × 6/12) + 25 (W2) + 500 impairment)</td>
<td>(5,625)</td>
</tr>
<tr>
<td>Finance costs (500 + (300 × 6/12))</td>
<td>(650)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>9,325</td>
</tr>
<tr>
<td>Income tax expense (1,400 + (900 × 6/12))</td>
<td>(1,850)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>7,475</td>
</tr>
</tbody>
</table>

Other comprehensive income:
- Gain on property revaluation (post-acquisition) 2,000
- Gain on investment in equity instrument 200

Total comprehensive income for the year 9,675

Profit attributable to:
- Owners of the parent 6,925
- Non-controlling interest (W3) 550

Total comprehensive income attributable to:
- Owners of the parent 8,325
- Non-controlling interest (550 + (2,000 × 40%)) 1,350

Workings

1 Unrealised profit
   Remove intercompany trading:
   DR Revenue $6,000,000; CR Cost of sales $6,000,000
   Unrealised profit = 6,000,000 × 20/120 = 1,000,000:
   DR Cost of sales $1,000,000; CR Inventories $1,000,000
   As the parent company is the selling company, none of the unrealised profit is allocated to the non-controlling interest.

2 Movement on fair value adjustment
   The fair value adjustment of $1m will be depreciated over the remaining life of the building. The amount to be charged at 31 December is:
   1,000,000/20 × 6/12 = 25,000
   40% of this (10,000) will be attributable to the NCI.

3 Non-controlling interest – share of profit for the year

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of post-acquisition profit (3,800,000 × 6/12 × 40%)</td>
<td>760</td>
</tr>
<tr>
<td>Movement on fair value adjustment (25,000 × 40%) (W2)</td>
<td>(10)</td>
</tr>
<tr>
<td>Share of goodwill impairment (500,000 × 40%)</td>
<td>(200)</td>
</tr>
<tr>
<td>Total</td>
<td>550</td>
</tr>
</tbody>
</table>
Owners of the parent – share of profit for the year

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>C Profit for the year</td>
<td>9,100</td>
</tr>
<tr>
<td>Dividend received</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Share of P's profit for the year (3,800,000 × 6/12 × 60%)</td>
<td>1,140</td>
</tr>
<tr>
<td>Share of fair value adjustment (25,000 × 60%)</td>
<td>(15)</td>
</tr>
<tr>
<td>Share of goodwill impairment (500,000 × 60%)</td>
<td>(300)</td>
</tr>
<tr>
<td>Unrealised profit</td>
<td>(1,000)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>6,925</strong></td>
</tr>
</tbody>
</table>

**SECTION SUMMARY**

A consolidated statement of profit or loss and other comprehensive income is prepared by:

(a) Adding income and expenses, eliminating intragroup transactions and adjusting for any unrealised profits

(b) Eliminating dividend income from the subsidiary

(c) Allocating a share of the profits and total comprehensive income to the NCI
Consolidated financial statements

- Consolidated statement of financial position
  - Add 100% of assets and liabilities of parent and subsidiary
  - Eliminate investment in subsidiary against share capital and pre-acquisition reserves
  - Eliminate intragroup balances and unrealised profits
  - Goodwill/ bargain purchase

- Consolidated statement of profit or loss and other comprehensive income
  - Add 100% of income expense of parent and subsidiary
  - Recognise non-controlling interest
  - Adjust for unrealised profits
  - Eliminate dividend income from subsidiary
  - Allocate share of profits and other comprehensive income to NCI
Quick Quiz

1. How is the consolidated statement of financial position adjusted for an unrealised profit in inventory?
2. What consolidation adjustment is required to recognise goodwill on acquisition?
3. How is cost of sales in the consolidated statement of profit or loss calculated?
Answers to Quick Quiz

1. Upon consolidation, the unrealised profit is removed from inventory and removed from retained earnings (DR retained earnings, CR Inventories); where the subsidiary is the selling company and there is a non-controlling interest, a proportion of the unrealised profit adjustment is allocated to the NCI (DR Retained earnings, DR NCI, CR Inventories).

2. DEBIT Goodwill
   DEBIT Share capital of subsidiary
   DEBIT Reserves of subsidiary
   CREDIT NCI
   CREDIT Investment in subsidiary

3. Parent's COS + Subsidiary's COS – intragroup transactions + unrealised profit in inventory

Answers to Questions

25.1 Elimination

P CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE

<table>
<thead>
<tr>
<th>Assets</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>220,000</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
</tr>
<tr>
<td>Inventories (50,000 + 60,000) + 6,000*</td>
<td>116,000</td>
</tr>
<tr>
<td>Receivables (40,000 + 30,000)</td>
<td>70,000</td>
</tr>
<tr>
<td>Cash (4,000 + 6,000)</td>
<td>10,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>196,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity and liabilities</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital (parent)</td>
<td>100,000</td>
</tr>
<tr>
<td>Retained earnings (95,000 + 28,000)</td>
<td>123,000</td>
</tr>
<tr>
<td>Non-current liabilities</td>
<td></td>
</tr>
<tr>
<td>10% loan stock</td>
<td>75,000</td>
</tr>
<tr>
<td>12% loan stock (50,000 x 60%)</td>
<td>30,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
</tr>
<tr>
<td>Payables (47,000 + 16,000)</td>
<td>63,000</td>
</tr>
<tr>
<td>Taxation (15,000 + 10,000)</td>
<td>25,000</td>
</tr>
<tr>
<td>Total equity and liabilities</td>
<td>88,000</td>
</tr>
</tbody>
</table>

* Goods in transit (18,000 – 12,000). The required consolidation adjustment is Dr Inventories $6,000, Cr Amount due to P Co $6,000.

Note especially how:
(a) The uncancelled loan stock in S Co becomes a liability of the group
(b) The goods in transit is the difference between the current accounts ($18,000 – $12,000)
(c) The investment in S Co's shares is cancelled against S Co's share capital
25.2 Consolidated statement of financial position

Workings

1  Consideration transferred

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash paid</td>
<td>30,000</td>
</tr>
<tr>
<td>Fair value of deferred consideration (10,000 × 1/(1.07(^2)))</td>
<td>8,734</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>38,734</strong></td>
</tr>
</tbody>
</table>

* Note that the deferred consideration has been discounted at 7% for two years (1 July 20X7 to 1 July 20X9).

However, at the date of the current financial statements, 30 June 20X8, the discount for one year has unwound. The amount of the discount unwound is

$\left(10,000 \times \frac{1}{1.07}\right) - 8,734 = 612$

So this amount was charged to finance costs in the consolidated financial statements of Ping and the deferred consideration under liabilities will be shown as $9,346 (8,734 + 612).

Adjustment journal (in $)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance cost (Profit and loss)</td>
<td>Deferred consideration</td>
<td>612</td>
</tr>
<tr>
<td></td>
<td></td>
<td>612</td>
</tr>
</tbody>
</table>

to record the unwinding of discount in Ping's books

2  Calculate goodwill

Goodwill

<table>
<thead>
<tr>
<th></th>
<th>Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred (W1)</td>
<td>38,734</td>
</tr>
<tr>
<td>Fair value of NCI</td>
<td>9,000</td>
</tr>
<tr>
<td>Net assets acquired as represented by:</td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>25,000</td>
</tr>
<tr>
<td>Revaluation surplus on acquisition</td>
<td>5,000</td>
</tr>
<tr>
<td>Retained earnings on acquisition</td>
<td>6,000</td>
</tr>
<tr>
<td>Intangible asset – brand name</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
<td><strong>(41,000)</strong></td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
<td><strong>6,734</strong></td>
</tr>
</tbody>
</table>

This goodwill must be capitalised in the consolidated statement of financial position.

Note that the brand would not have been included in the subsidiary's individual financial statements.

Consolidation adjustment journal (in $)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>Investment</td>
<td>38,734</td>
</tr>
<tr>
<td>Goodwill</td>
<td>Share capital</td>
<td>25,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>Revaluation surplus</td>
<td>5,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>Retained earnings</td>
<td>6,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>Intangible asset</td>
<td>5,000</td>
</tr>
<tr>
<td>NCI</td>
<td></td>
<td>9,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

to recognise the initial goodwill and NCI on acquisition
3. **Calculate post-acquisition profits attributable to NCI**

**Consolidated retained earnings**

<table>
<thead>
<tr>
<th></th>
<th>Pong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings per question</td>
<td>28,000</td>
</tr>
<tr>
<td>Less pre-acquisition</td>
<td>(6,000)</td>
</tr>
<tr>
<td>NCI share 20% × $22,000</td>
<td>4,400</td>
</tr>
</tbody>
</table>

**Consolidation adjustment journal (in $)**

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Retained earnings</th>
<th>4,400</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td>NCI</td>
<td>4,400</td>
</tr>
</tbody>
</table>

to allocate post-acquisition profits in Pong to the NCI

4. **Agree current accounts**

Pong Co has cash in transit of $2,000 which should be added to cash and deducted from the amount owed by Ping Co.

Cancel common items: these are the current accounts between the two companies of $8,000 each.

**Consolidation adjustment journal (in $)**

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Cash</th>
<th>2,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Owed to Ping</td>
<td>8,000</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Owed by Ping</td>
<td>10,000</td>
</tr>
</tbody>
</table>

To record cash in transit and cancel intragroup balances.

5. **Consolidation schedule**

<table>
<thead>
<tr>
<th></th>
<th>Ping</th>
<th>Pong</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>Consol</th>
</tr>
</thead>
<tbody>
<tr>
<td>PPE</td>
<td>50,000</td>
<td>40,000</td>
<td></td>
<td></td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>Investment</td>
<td>38,734</td>
<td></td>
<td>(38,734)</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td>6,734</td>
<td></td>
<td>6,734</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brand</td>
<td></td>
<td>5,000</td>
<td></td>
<td>5,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>3,000</td>
<td>8,000</td>
<td></td>
<td></td>
<td>11,000</td>
<td></td>
</tr>
<tr>
<td>Owed by Ping</td>
<td></td>
<td>10,000</td>
<td></td>
<td></td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>16,000</td>
<td>7,000</td>
<td></td>
<td></td>
<td>23,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>2,000</td>
<td></td>
<td>2,000</td>
<td></td>
<td>4,000</td>
<td>139,734</td>
</tr>
<tr>
<td>Sh capital</td>
<td>45,000</td>
<td>25,000</td>
<td>(25,000)</td>
<td></td>
<td></td>
<td>45,000</td>
</tr>
<tr>
<td>Revaluation reserve</td>
<td>12,000</td>
<td>5,000</td>
<td>(5,000)</td>
<td></td>
<td></td>
<td>12,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>25,388</td>
<td>28,000</td>
<td>(6,000)</td>
<td>(4,400)</td>
<td>42,988</td>
<td></td>
</tr>
<tr>
<td>NCI</td>
<td></td>
<td>9,000</td>
<td>4,400</td>
<td></td>
<td></td>
<td>13,400</td>
</tr>
<tr>
<td>Owed to Pong</td>
<td>8,000</td>
<td></td>
<td>(8,000)</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payables</td>
<td>10,000</td>
<td>7,000</td>
<td></td>
<td></td>
<td>17,000</td>
<td></td>
</tr>
<tr>
<td>Deferred consideration</td>
<td>9,346</td>
<td></td>
<td></td>
<td></td>
<td>9,346</td>
<td></td>
</tr>
</tbody>
</table>

139,734
6. **Prepare the consolidated statement of financial position.**

**PING CO**

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X8

<table>
<thead>
<tr>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td><strong>Equity and liabilities</strong></td>
</tr>
<tr>
<td><strong>Non-current assets</strong></td>
<td><strong>Equity</strong></td>
</tr>
<tr>
<td>Property, plant and equipment (50,000 + 40,000)</td>
<td>Ordinary share capital (Ping Co only)</td>
</tr>
<tr>
<td>90,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Intangible assets: Goodwill (W2)</td>
<td>Revaluation surplus</td>
</tr>
<tr>
<td>6,734</td>
<td>12,000</td>
</tr>
<tr>
<td>Brand name</td>
<td>Retained earnings (W5)</td>
</tr>
<tr>
<td>5,000</td>
<td>42,988</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td><strong>Non-controlling interest (W5)</strong></td>
</tr>
<tr>
<td>Inventories (3,000 + 8,000)</td>
<td>11,000</td>
</tr>
<tr>
<td>11,000</td>
<td>13,400</td>
</tr>
<tr>
<td>Receivables (16,000 + 7,000)</td>
<td><strong>Total equity and liabilities</strong></td>
</tr>
<tr>
<td>23,000</td>
<td>139,734</td>
</tr>
<tr>
<td>Cash (2,000 + 2,000)</td>
<td>4,000</td>
</tr>
<tr>
<td>4,000</td>
<td><strong>Total assets</strong></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>139,734</strong></td>
</tr>
</tbody>
</table>

Note: The following is proof of the retained earnings balance. This working is not required to complete the question if a consolidation schedule approach is used, as is the case here.

<table>
<thead>
<tr>
<th>$</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ping's retained earnings</td>
<td>25,388</td>
</tr>
<tr>
<td>Share of Pong's post acquisition retained earnings (28,000 – 6,000) \times 80%</td>
<td>17,600</td>
</tr>
<tr>
<td>42,988</td>
<td></td>
</tr>
</tbody>
</table>

### 25.3 Unrealised profit

**P CO**

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

<table>
<thead>
<tr>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td><strong>Equity and liabilities</strong></td>
</tr>
<tr>
<td><strong>Non-current assets</strong></td>
<td><strong>Equity</strong></td>
</tr>
<tr>
<td>Property, plant and equipment (80,000 + 40,000)</td>
<td>Ordinary share capital (P Co only)</td>
</tr>
<tr>
<td>120,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Goodwill (W1)</td>
<td>Retained earnings (W2)</td>
</tr>
<tr>
<td>15,000</td>
<td>52,200</td>
</tr>
<tr>
<td><strong>Current assets (W3)</strong></td>
<td><strong>Non-controlling interest (W5)</strong></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>190,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td><strong>Total equity and liabilities</strong></td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td><strong>Non-controlling interest (W5)</strong></td>
</tr>
<tr>
<td>Ordinary share capital (P Co only)</td>
<td>152,200</td>
</tr>
<tr>
<td>Retained earnings (W2)</td>
<td>10,800</td>
</tr>
<tr>
<td><strong>Current liabilities (W4)</strong></td>
<td><strong>27,000</strong></td>
</tr>
<tr>
<td><strong>Total equity and liabilities</strong></td>
<td><strong>190,000</strong></td>
</tr>
</tbody>
</table>
Workings

1. **Goodwill**

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>46,000</td>
</tr>
<tr>
<td>Fair value of non-controlling interest</td>
<td>9,000</td>
</tr>
<tr>
<td>Net assets acquired as represented by</td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>30,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td>(40,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>15,000</td>
</tr>
</tbody>
</table>

2. **Retained earnings**

<table>
<thead>
<tr>
<th>Description</th>
<th>P Co</th>
<th>S Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings per question</td>
<td>45,000</td>
<td>22,000</td>
</tr>
<tr>
<td>Unrealised profit: 20% × $15,000</td>
<td></td>
<td>(3,000)</td>
</tr>
<tr>
<td>Pre-acquisition</td>
<td>(10,000)</td>
<td></td>
</tr>
<tr>
<td>Share of S Co 80%</td>
<td>7,200</td>
<td>52,200</td>
</tr>
</tbody>
</table>

3. **Current assets**

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>In P Co's statement of financial position</td>
<td>40,000</td>
</tr>
<tr>
<td>In S Co's statement of financial position</td>
<td>30,000</td>
</tr>
<tr>
<td>Less S Co's current account with P Co cancelled</td>
<td>(12,000)</td>
</tr>
<tr>
<td></td>
<td>18,000</td>
</tr>
<tr>
<td></td>
<td>58,000</td>
</tr>
<tr>
<td>Less unrealised profit excluded from inventory valuation</td>
<td>(3,000)</td>
</tr>
<tr>
<td></td>
<td>55,000</td>
</tr>
</tbody>
</table>

4. **Current liabilities**

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>In P Co's statement of financial position</td>
<td>21,000</td>
</tr>
<tr>
<td>Less P Co's current account with S Co cancelled</td>
<td>(12,000)</td>
</tr>
<tr>
<td></td>
<td>9,000</td>
</tr>
<tr>
<td>In S Co's statement of financial position</td>
<td>18,000</td>
</tr>
<tr>
<td></td>
<td>27,000</td>
</tr>
</tbody>
</table>

5. **Non-controlling interest**

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value at date of acquisition</td>
<td>9,000</td>
</tr>
<tr>
<td>Share of post-acquisition retained earnings (9,000 × 20%)</td>
<td>1,800</td>
</tr>
<tr>
<td></td>
<td>10,800</td>
</tr>
</tbody>
</table>

### 25.4 Acquisition

Ruan Seng Co has made a profit of $24,000 ($39,000 – $15,000) for the year. In the absence of any direction to the contrary, this should be assumed to have arisen evenly over the year; $6,000 in the three months to 31 March and $18,000 in the nine months after acquisition. The company’s pre-acquisition retained earnings are therefore as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 31 December 20X4</td>
<td>15,000</td>
</tr>
<tr>
<td>Profit for three months to 31 March 20X5</td>
<td>6,000</td>
</tr>
<tr>
<td>Pre-acquisition retained earnings</td>
<td>21,000</td>
</tr>
</tbody>
</table>
The consolidation workings can now be drawn up.

1. **Goodwill**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>$50,000</td>
</tr>
<tr>
<td>Non-controlling interest ($2.50 × 4,000)</td>
<td>$10,000</td>
</tr>
<tr>
<td>Net assets acquired represented by</td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>$14,000</td>
</tr>
<tr>
<td>Retained earnings (pre-acquisition)</td>
<td>$21,000</td>
</tr>
<tr>
<td><strong>Goodwill at acquisition</strong></td>
<td>$25,000</td>
</tr>
</tbody>
</table>

**Consolidation adjustment journal (in $)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT Goodwill</td>
<td>$25,000</td>
</tr>
<tr>
<td>DEBIT Ordinary share capital</td>
<td>$14,000</td>
</tr>
<tr>
<td>DEBIT Retained earnings</td>
<td>$21,000</td>
</tr>
<tr>
<td>CREDIT Investment</td>
<td>$50,000</td>
</tr>
<tr>
<td>CREDIT NCI</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

To record goodwill arising on the acquisition of Ruan Seng Co.

2. **Retained earnings**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ruan Seng Co</td>
<td></td>
</tr>
<tr>
<td>Per question</td>
<td>$39,000</td>
</tr>
<tr>
<td>Pre-acquisition (see above)</td>
<td>$(21,000)</td>
</tr>
<tr>
<td>Share of Ruan Seng allocated to NCI</td>
<td>$3,600</td>
</tr>
</tbody>
</table>

**Consolidation adjustment journal (in $)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT Retained earnings</td>
<td>$3,600</td>
</tr>
<tr>
<td>CREDIT NCI</td>
<td>$3,600</td>
</tr>
</tbody>
</table>

Therefore group retained earnings are:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Han Loo Co</td>
<td>$40,000</td>
</tr>
<tr>
<td>Ruan Seng Co</td>
<td>$39,000</td>
</tr>
<tr>
<td>Pre-acquisition</td>
<td>$(21,000)</td>
</tr>
<tr>
<td>Allocated to NCI</td>
<td>$(3,600)</td>
</tr>
</tbody>
</table>

**Total retained earnings**

$54,400

---

**HAN LOO CO**

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Assets</em></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment (32,000 + 30,000)</td>
<td>$62,000</td>
</tr>
<tr>
<td>Goodwill (W1)</td>
<td>$25,000</td>
</tr>
<tr>
<td>Current assets (85,000 + 43,000)</td>
<td>$128,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$215,000</td>
</tr>
</tbody>
</table>
25.5 Acquisition

The shares in S Co were acquired three months into the year. Only the post-acquisition proportion \( \frac{9}{12} \) of S Co’s statement of profit or loss is included in the consolidated statement of profit or loss. This is shown separately in the question for convenience.

P Co Consolidated Statement of Profit or Loss

For the Year Ended 31 December 20X5

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue (170,000 + 60,000)</td>
<td>230,000</td>
</tr>
<tr>
<td>Cost of sales (65,000 + 27,000)</td>
<td>(92,000)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>138,000</td>
</tr>
<tr>
<td>Administrative expenses (43,000 + 9,000)</td>
<td>(52,000)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>86,000</td>
</tr>
<tr>
<td>Income tax expense (23,000 + 6,000)</td>
<td>(29,000)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>57,000</td>
</tr>
</tbody>
</table>

Profit attributable to:
- Owners of the parent: 49,800
- Non-controlling interest (18,000 × 40%): 7,200

Total: 57,000

Consolidated Statement of Changes in Equity (extracts)

<table>
<thead>
<tr>
<th></th>
<th>Retained earnings</th>
<th>Non-controlling interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 1 January 20X5</td>
<td>81,000</td>
<td>–</td>
</tr>
<tr>
<td>Dividends paid (6,000 – 3,600) or (6,000 × 40%)</td>
<td>(12,000)</td>
<td>(2,400)</td>
</tr>
<tr>
<td>Total comprehensive income for the year</td>
<td>49,800</td>
<td>7,200</td>
</tr>
<tr>
<td>Added on acquisition of subsidiary (W)</td>
<td>–</td>
<td>58,400</td>
</tr>
<tr>
<td>Balance at 31 December 20X5</td>
<td>118,800</td>
<td>63,200</td>
</tr>
</tbody>
</table>

Note: All of S Co’s profits brought forward are pre-acquisition.

Working

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Added on acquisition of subsidiary:</td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>100,000</td>
</tr>
<tr>
<td>Retained earnings brought forward</td>
<td>40,000</td>
</tr>
<tr>
<td>Profits Jan–March 20X5 (24,000 – 18,000)</td>
<td>6,000</td>
</tr>
<tr>
<td></td>
<td>146,000</td>
</tr>
<tr>
<td>Non-controlling share 40%</td>
<td>58,400</td>
</tr>
</tbody>
</table>
### 25.6 Mid-year acquisition

**ORCHARD HOSPITALITY CO**

**CONSOLIDATED STATEMENT OF PROFIT OR LOSS**

**FOR THE YEAR ENDED 30 APRIL 20X7**

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue (1,100 + (500 × 6/12))</td>
<td>1,350</td>
</tr>
<tr>
<td>Cost of sales (630 + (300 × 6/12))</td>
<td>(780)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>570</td>
</tr>
<tr>
<td>Administrative expenses (105 + (150 × 6/12))</td>
<td>(180)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>390</td>
</tr>
<tr>
<td>Income tax expense (65 + (10 × 6/12))</td>
<td>(70)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>320</td>
</tr>
</tbody>
</table>

**Profit attributable to:**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Owners of the parent</td>
<td>316</td>
</tr>
<tr>
<td>Non-controlling interest (W1)</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>320</td>
</tr>
</tbody>
</table>

**CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (extract)**

<table>
<thead>
<tr>
<th></th>
<th>Retained earnings</th>
<th>Non-controlling interests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance brought forward 1 May 20X6</td>
<td>460</td>
<td>–</td>
</tr>
<tr>
<td>Added on acquisition of subsidiary (W2)</td>
<td>–</td>
<td>210</td>
</tr>
<tr>
<td>Total comprehensive income for the year</td>
<td>316</td>
<td>4</td>
</tr>
<tr>
<td>Dividends paid – per Q (30,000 – 24,000) or 30,000 × 20%</td>
<td>(200)</td>
<td>(6)</td>
</tr>
<tr>
<td>Balance carried forward 30 April 20X7</td>
<td>576</td>
<td>208</td>
</tr>
</tbody>
</table>

**Workings**

1. **Non-controlling interests**

   In Lucky Foods (20% × $40,000 × 1/2)

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>In Lucky Foods (20% × $40,000 × 1/2)</td>
<td>4</td>
</tr>
</tbody>
</table>

2. **Added on acquisition of subsidiary**

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>1,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>52</td>
</tr>
<tr>
<td></td>
<td>1,052</td>
</tr>
<tr>
<td>Non-controlling share 20% (rounded to nearest $'000)</td>
<td>210</td>
</tr>
</tbody>
</table>
This chapter expands on the definitions of associate and joint arrangement that we saw in Chapter 25 and explains the accounting procedures applicable to each.
We looked at investments in associates briefly in Chapter 24, and defined an associate as ‘an entity (including an unincorporated entity such as a partnership) over which an investor has significant influence and which is neither a subsidiary nor a joint venture of the investor’.

A key term is therefore significant influence.

### 1.1 Significant influence

**KEY TERM**

*Significant influence* is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

Significant influence can be determined by the holding of voting rights (usually attached to shares) in the entity. SFRS(I) 1-28 states that if an investor holds (directly or indirectly) **20% or more** of the voting power of the investee, it can be presumed that the investor has significant influence over the investee, unless it can be clearly shown that this is not the case. However, significant influence is not the same as control or joint control. You should now re-read the definitions in SFRS(I) 1-28, SFRS(I) 10 and SFRS(I) 11 to ensure you understand the differences between significant influence, control and joint control. Note that in the definition of significant influence, the focus is the power to participate; it does not matter whether the power is actually exercised.
Significant influence can be presumed not to exist if the investor holds less than 20% of the voting power of the investee, unless it can be demonstrated otherwise.

The existence of significant influence is evidenced in one or more of the following ways.

(a) Representation on the board of directors (or equivalent) of the investee
(b) Participation in the policy making process including decisions regarding dividends and other distributions
(c) Material transactions between investor and investee
(d) Interchange of management personnel
(e) Provision of essential technical information

1.1.1 Potential voting rights

When assessing significant influence, the existence of potential voting rights owned by the investing entity and other parties should be considered.

Potential voting rights are associated with financial instruments that have the potential, if converted or exercised, to give an entity additional voting power. They include share warrants, share call options and financial instruments that are convertible into ordinary shares such as convertible debt.

Potential voting rights may only contribute to significant influence when they are currently exercisable or convertible. In assessing whether such rights do contribute to significant influence, all facts and circumstances should be considered with the exception of the intentions of management and the financial ability to exercise or convert the potential rights.

1.2 Accounting treatment of associates

1.2.1 Consolidated financial statements

SFRS(I) 1-28 requires all investments in associates (and joint ventures, which we discuss later in the chapter) to be accounted for using the equity method, unless one of the following applies:

(a) The investment is classified as 'held for sale' in accordance with SFRS(I) 5 in which case it should be accounted for under SFRS(I) 5 (see Chapter 21).
(b) The investment is held by a venture capital organisation (or similar). In this case it may elect to measure that investment at fair value through profit or loss. This election is made on an investment-by-investment basis on initial recognition.
(c) The following exemption applies.

An investor is exempt from applying the equity method if:

(a) It is a parent exempt from preparing consolidated financial statements under SFRS(I) 10, para. 4a; or
(b) All of the following apply:
   (i) The investor is a wholly-owned subsidiary or it is a partially owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method;
   (ii) Its securities are not publicly traded;
   (iii) It is not in the process of issuing securities in public securities markets; and
   (iv) The ultimate or intermediate parent produces consolidated financial statements available for public use in which subsidiaries are consolidated or measured through profit or loss.

Exemption (b) therefore applies even where the investor's ultimate or intermediate parent is an investment entity as defined by SFRS(I) 10 (Chapter 24) and it measures its investments at fair value in its consolidated financial statements.
SFRS(I) 1-28 does not allow an investment in an associate to be excluded from equity accounting when an investee operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor. Significant influence must be lost before the equity method ceases to be applicable (see section 1.9).

SFRS(I) 9 does not apply to interests in associates that are accounted for using the equity method, however SFRS(I) 9 should be applied to instruments containing potential voting rights that do not currently give access to returns associated with an ownership interest. IFRS 9 (SFRS(I) 9) is applied to the financial instruments in an associate to which the equity method is not applied, including those long-term interests that in substance form part of the investor’s net investment in the associate.

1.2.2 Separate financial statements of investor

In the separate financial statements of the investor, an interest in an associate is accounted for either:

- At cost;
- In accordance with SFRS(I) 9; or
- By applying equity accounting in line with SFRS(I) 1-28.

1.3 The equity method

**KEY TERM**

EQUITY METHOD A method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

Many of the procedures required to apply the equity method are the same as are required for full consolidation. In particular, fair value adjustments are required and the group share of intragroup unrealised profits must be excluded.

1.3.1 Consolidated statement of profit or loss and other comprehensive income

The basic principle in the statement of profit or loss and other comprehensive income is that the investing group (X Group) should take account of its share of the earnings of the associate, Y Co, whether or not Y Co distributes the earnings as dividends. X Group achieves this by:

(a) Adding to consolidated profit the group's share of Y Co's profit after tax

(b) Adding to consolidated other comprehensive income the group share of Y Co's other comprehensive income after tax

Y Co's profit for the purposes of equity accounting is based on the fair value of its net assets at acquisition. Therefore adjustments may be required eg to ensure that depreciation charges are calculated on fair value.

Notice that this treatment and the consolidation of a subsidiary company's results is different yet has the same net effect:

(a) If Y Co were a subsidiary X Group would take credit for all of its total comprehensive income on a line by line basis and then allocate the proportion that 'belongs' to the NCI to the NCI, leaving the group with the proportion of total comprehensive income which does 'belong' to it.

(b) Under equity accounting, the group only recognises its own share of the total comprehensive income in the first place.
The following is a **suggested layout** (for a statement of profit or loss and other comprehensive income) for a company having subsidiaries as well as associates.

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>1,400</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(770)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>630</td>
</tr>
<tr>
<td>Distribution costs and administrative expenses</td>
<td>(290)</td>
</tr>
<tr>
<td>Interest and similar income receivable</td>
<td>30</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(20)</td>
</tr>
<tr>
<td>Share of profit (after tax) of associate</td>
<td>17</td>
</tr>
<tr>
<td>Profit before taxation</td>
<td>367</td>
</tr>
<tr>
<td>Income tax expense</td>
<td></td>
</tr>
<tr>
<td>Parent company and subsidiaries</td>
<td>(145)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>222</td>
</tr>
<tr>
<td>Other comprehensive income:</td>
<td></td>
</tr>
<tr>
<td>Revaluation surplus</td>
<td>60</td>
</tr>
<tr>
<td>Total comprehensive income</td>
<td>282</td>
</tr>
<tr>
<td>Profit attributable to:</td>
<td></td>
</tr>
<tr>
<td>Owners of the parent</td>
<td>200</td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>22</td>
</tr>
<tr>
<td>Total comprehensive income attributable to:</td>
<td>282</td>
</tr>
<tr>
<td>Owners of the parent</td>
<td>260</td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>22</td>
</tr>
</tbody>
</table>

### 1.3.2 Consolidated statement of financial position

A figure for **investment in associates** is shown in the consolidated statement of financial position.

At the time of the acquisition this is stated at cost; this amount will increase (decrease) each year by the amount of the group's share of the associate's total comprehensive income retained for the year such that the investment in an associate can be calculated as:

\[
\text{Investment in associate} = \text{Cost of investment} \times (\text{Group share of post-acquisition profits/losses}) \times (\text{Group share of post-acquisition other comprehensive income}) \times (\text{Loans to/from associate}) \times (\text{Dividends paid by associate to parent since acquisition}) \times (\text{Impairments}) \times (\text{Investment in associate})
\]

The investment may be impaired in which case accumulated impairment losses reduce the carrying amount; this is discussed in more detail later.

The group share of the associate's reserves are also included within the group reserves figure in the equity section of the consolidated statement of financial position.

Note: In practice, loans to or from associate may not form part of investment in associates, only long term loans which are not expected to be repaid are treated as such.
1.3.3 Required journals

When preparing a consolidated statement of financial position and using the separate financial statements as a starting point, the cost of an associate is already represented as an asset of the parent company (investment in associate).

A consolidation journal is therefore required to recognise the post-acquisition total comprehensive income of the associate in both the carrying amount of the investment and reserves:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in associate</td>
<td>Reserves</td>
</tr>
</tbody>
</table>

To recognise the post-acquisition total comprehensive income of the associate.

As we have said, the profit and other comprehensive income earned in the current year is also included in the consolidated statement of profit or loss and other comprehensive income.

Example

Associate

P Co, a company with subsidiaries, acquires 25,000 of the 100,000 ordinary shares in A Co for $60,000 on 1 January 20X8. In the year to 31 December 20X8, A Co earns profits after tax of $24,000, from which it declares a dividend of $6,000.

How will A Co's results be accounted for in the separate and consolidated financial statements of P Co for the year ended 31 December 20X8?

Solution

Assuming it elects to account for it at cost, in the separate financial statements of P Co, the investment will be recorded on 1 January 20X8 at $60,000. Unless there is an impairment in the value of the investment, this amount will remain in the individual statement of financial position of P Co permanently. The only entry in P Co's statement of profit or loss and other comprehensive income will be to record dividends received. For the year ended 31 December 20X8, P Co will ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,500</td>
</tr>
<tr>
<td>Income from shares in associates</td>
<td>1,500</td>
</tr>
</tbody>
</table>

In the consolidated financial statements of P Co equity accounting principles will be used to account for the investment in A Co. Consolidated profit after tax will include the group's share of A Co's profit after tax (25% × $24,000 = $6,000). To the extent that this has been distributed as dividend, it is already included in P Co's individual accounts and will automatically be brought into the consolidated results. It must, however be reclassified as 'share of profits of associates' rather than 'income from shares in associates'. In addition, that part of the group's profit share that has not been distributed as dividend ($4,500) is brought into the consolidation by the following adjustment ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from shares in associates</td>
<td>1,500</td>
</tr>
<tr>
<td>Investment in associates</td>
<td>4,500</td>
</tr>
<tr>
<td>Share of profit of associates</td>
<td>6,000</td>
</tr>
</tbody>
</table>

The asset 'Investment in associates' is then stated at $64,500, being cost plus the group share of post-acquisition retained profits.

1.4 Other accounting considerations

The following points are also relevant and are similar to a parent-subsidiary consolidation situation.

(a) Use financial statements drawn up to the same reporting date.

(b) If this is impracticable, adjust the financial statements for significant transactions/events in the intervening period. The difference between the reporting date of the associate and that of the investor must be no more than three months.
Use uniform accounting policies for like transactions and events in similar circumstances, adjusting the associate's statements to reflect group policies if necessary. This requirement does not apply where an associate is an investment entity that measures its interests in subsidiaries at fair value.

If an associate has cumulative preference shares held by outside interests, calculate the share of the investor's profits/losses after adjusting for the preferred dividends (whether or not declared).

1.5 'Upstream' and 'downstream' transactions

A group (made up of a parent and its consolidated subsidiaries) may trade with its associates. This introduces the possibility of unrealised profits if goods sold within the group are still held in inventories at the end of the period. This is similar to unrealised profits arising on trading between a parent and a subsidiary. The important thing to remember is that when an associate is involved, only the group's share is eliminated.

The precise accounting entries depend on the direction of the transaction. 'Upstream' transactions are sale of assets from an associate to the investor. 'Downstream' transactions are sales of assets from the investor to an associate.

The double entry is as follows, where A% is the parent's holding in the associate, and PUP is the provision for unrealised profit.

**DEBIT**
- Share of profit of associate (and so retained earnings of parent or subsidiary)  $PUP \times A\%$
- Group inventories  $PUP \times A\%$

**CREDIT**
- For upstream transactions (associate sells to parent or subsidiary) where the parent or subsidiary holds the inventories.
  - Cost of sales (and so retained earnings of parent or subsidiary)  $PUP \times A\%$
  - Investment in associate  $PUP \times A\%$

For downstream transactions, (parent/subsidiary sells to associate) where the associate holds the inventory.

**Example**

This is a downstream transaction; A Co, a parent with subsidiaries, holds 25% of the equity shares in B Co. During the year, A Co makes sales of $1,000,000 to B Co at cost plus a 25% mark-up. At the year-end, B Co has all these goods still in inventories.

What consolidation adjustment (relating to the SOFP) is required in respect of the transaction?

**Solution**

A Co has made an unrealised profit of $200,000 (1,000,000 \times 25/125) on its sales to the associate. The group's share of this is 25%, ie $50,000. This must be eliminated.

The double entry is ($):

**DEBIT**
- A: Retained earnings  50,000
- A: Investment in associate (B)  50,000

**CREDIT**
- Because the sale was made to the associate, the group's share of the unsold inventories forms part of the investment in associate at the year-end. If the sale had been from the associate B to A, ie an upstream transaction, the double entry would have been ($):

**DEBIT**
- A: Retained earnings  50,000
- A: Inventories  50,000
If preparing the consolidated statement of profit or loss and other comprehensive income, you would add the $50,000 to cost of sales, as the parent made the sales in this example.

### 1.5.1 Transfer of assets that constitute a business

Note that the accounting treatment described above for downstream transactions (from the parent to associate) relates only to assets that do not constitute a business as defined in SFRS(I) 3 Business Combinations.

An amendment to SFRS(I) 1-28 made in 2014 introduces a requirement to recognise in full in the investor's financial statements any gains or losses from downstream transactions involving assets that do constitute a business. The effective date of this amendment has been delayed indefinitely.

When deciding whether assets transferred constitute a business, SFRS(I) 1-28 requires that assets sold in multiple arrangements may need to be accounted for as a single transaction.

### 1.6 Loss making associate

When the equity method is being used and the investor's share of losses of the associate equals or exceeds its interest in the associate, the investor should discontinue including its share of further losses.

The investment is reported at nil value. The interest in the associate is normally the carrying amount of the investment in the associate, but it also includes any other long-term interests, for example, preference shares or long-term receivables or loans.

After the investor's interest is reduced to nil, additional losses should only be recognised where the investor has incurred obligations or made payments on behalf of the associate (for example, if it had guaranteed amounts owed to third parties by the associate and has now made a payment under this guarantee).

Should the associate return to profit, the parent may resume recognising its share of profits only after they equal the share of losses not recognised.

### 1.7 Impairment losses

SFRS(I) 9 Financial Instruments sets out a list of indications that a financial asset (including an associate) may have become impaired. Any impairment loss is recognised in accordance with SFRS(I) 1-36 Impairment of Assets for each associate as a single asset. There is no separate testing for impairment of goodwill, as the goodwill that forms part of the carrying amount of an investment in an associate is not separately recognised. An impairment loss is not allocated to any asset, including goodwill that forms part of the carrying amount of the investment in associate. Accordingly, any reversal of that impairment loss is recognised in accordance with SFRS(I) 1-36 to the extent that the recoverable amount of the investment subsequently increases.

### 1.8 Non-controlling interest/associate held by a subsidiary

Where the investment in an associate is held by a subsidiary in which there are non-controlling interests, the non-controlling interest shown in the consolidated financial statements of the group should include the non-controlling interest of the subsidiary's interest in the results and net assets of the associated entity.

This means that the group accounts must include the 'gross' share of net assets, pre-tax profits and tax, in accounting for the non-controlling interest separately. For example, we will suppose that P Co owns 60% of S Co which owns 25% of A Co, an associate of P Co. The relevant amounts for inclusion in the consolidated financial statements would be as follows.
Therefore:

\[
\begin{array}{c|c|c}
\text{S} & \text{A} \\
\hline
\text{Group interest in} & 60\% & (60\% \times 25\%) = 15\% \\
\text{Non-controlling interest in} & 40\% & (40\% \times 25\%) = 10\% \\
\hline
& 100\% & 25\%
\end{array}
\]

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Operating profit (P 100\% + S 100\%)
Share of profit after tax of associate (A 25\%)
Tax (P 100\% + S 100\%)
Profit attributable to:
Non-controlling interest (S 40\% + A 10\%*)
Owners of the parent (P 100\% + S 60\% + A 15\%)

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Investment in associate (figures based on 25\% holding)
Non-controlling interest ((40\% \times \text{shareholders' funds of S}) + (10\% \times \text{post-acq'rn retained earnings of A}))
Group retained earnings ((100\% \times P) + (60\% \times \text{post-acquisition of S}) + (15\% \times \text{post-acquisition reserves of A}))
* 40\% \times 25\% = 10\%

### 1.9 Loss of significant influence

Where an entity loses the power to participate in the financial and operating policy decisions of the investee it loses significant influence. This may be due to a change in absolute or relative ownership levels. However, it could also be due to other reasons, e.g., if the associate becomes subject to the control of a government, court or regulator or as a result of a contractual arrangement.

When an investment ceases to be an associate (or joint venture) the use of the equity method must be discontinued. The treatment depends on the nature of the remaining investment as follows:

- If the investment becomes a subsidiary the investment will be accounted for in accordance with SFRS(I) 3 Business Combinations and SFRS(I) 10 Consolidated Financial Statements.
If the investment becomes a financial asset the retained interest must be valued at fair value in accordance with SFRS(I) 9 Financial Instruments. Any difference between:

(a) The fair value of the retained interest and any proceeds from disposing of any part of the associate (or joint venture); and

(b) The carrying amount of the investment at the date that the use of the equity method was discontinued

must be recognised in profit or loss.

Any amounts previously recognised in other comprehensive income in relation to that investment should be accounted for on the same basis as would have been required if the related assets and liabilities had been disposed of directly by the investee.

1.10 Comprehensive question

**Question 26.1** Group accounting with deferred tax

Y, a public limited company, acquired a subsidiary, H, on 1 July 20X2 and an associate, L, on 1 July 20X5. The details of the acquisitions at the respective dates are as follows.

<table>
<thead>
<tr>
<th>Investee</th>
<th>Ordinary share capital</th>
<th>Number of ordinary shares</th>
<th>Reserves</th>
<th>Revaluation surplus</th>
<th>Fair value of net assets at acquisition</th>
<th>Cost of investment</th>
<th>Number of ordinary shares acquired</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
</tr>
<tr>
<td>H</td>
<td>540</td>
<td>400m</td>
<td>120</td>
<td>40</td>
<td>800</td>
<td>765</td>
<td>320m</td>
</tr>
<tr>
<td>L</td>
<td>303</td>
<td>220m</td>
<td>195</td>
<td>54</td>
<td>652</td>
<td>203</td>
<td>55m</td>
</tr>
</tbody>
</table>

The draft financial statements for the year ended 30 June 20X6 are as follows.

**STATEMENTS OF FINANCIAL POSITION AS AT 30 JUNE 20X6**

<table>
<thead>
<tr>
<th></th>
<th>Y $m</th>
<th>H $m</th>
<th>L $m</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-current assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>1,012</td>
<td>920</td>
<td>442</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>–</td>
<td>350</td>
<td>27</td>
</tr>
<tr>
<td>Investment in H</td>
<td>765</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Investment in L</td>
<td>203</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td></td>
<td>1,980</td>
<td>1,270</td>
<td>469</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>620</td>
<td>1,460</td>
<td>214</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>950</td>
<td>529</td>
<td>330</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>900</td>
<td>510</td>
<td>45</td>
</tr>
<tr>
<td></td>
<td>2,470</td>
<td>2,499</td>
<td>589</td>
</tr>
<tr>
<td></td>
<td>4,450</td>
<td>3,769</td>
<td>1,058</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>1,200</td>
<td>540</td>
<td>303</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,128</td>
<td>809</td>
<td>263</td>
</tr>
<tr>
<td>Revaluation surplus</td>
<td>142</td>
<td>70</td>
<td>62</td>
</tr>
<tr>
<td></td>
<td>2,470</td>
<td>1,419</td>
<td>628</td>
</tr>
<tr>
<td><strong>Non-current liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>100</td>
<td>50</td>
<td>36</td>
</tr>
<tr>
<td><strong>Current liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade and other payables</td>
<td>1,880</td>
<td>2,300</td>
<td>394</td>
</tr>
<tr>
<td></td>
<td>4,450</td>
<td>3,769</td>
<td>1,058</td>
</tr>
</tbody>
</table>
STATMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20X6

<table>
<thead>
<tr>
<th></th>
<th>Y ($m)</th>
<th>H ($m)</th>
<th>L ($m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>4,480</td>
<td>4,200</td>
<td>1,460</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(2,690)</td>
<td>(2,940)</td>
<td>(1,020)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,790</td>
<td>1,260</td>
<td>440</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>(620)</td>
<td>(290)</td>
<td>(196)</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(50)</td>
<td>(80)</td>
<td>(24)</td>
</tr>
<tr>
<td>Dividend income (from H and L)</td>
<td>260</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>1,380</td>
<td>890</td>
<td>220</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(330)</td>
<td>(274)</td>
<td>(72)</td>
</tr>
<tr>
<td>PROFIT FOR THE YEAR</td>
<td>1,050</td>
<td>616</td>
<td>148</td>
</tr>
<tr>
<td>Other comprehensive income that will not be reclassified to profit or loss</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain on revaluation of property</td>
<td>30</td>
<td>7</td>
<td>12</td>
</tr>
<tr>
<td>Income tax expense relating to other comp income</td>
<td>(9)</td>
<td>(2)</td>
<td>(4)</td>
</tr>
<tr>
<td>Other comprehensive income, net of tax</td>
<td>21</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>TOTAL COMPREHENSIVE INCOME FOR THE YEAR</td>
<td>1,071</td>
<td>621</td>
<td>156</td>
</tr>
</tbody>
</table>

OTHER EXCERPTS FROM FINANCIAL STATEMENTS AS AT 30 JUNE 20X6

<table>
<thead>
<tr>
<th></th>
<th>Y ($m)</th>
<th>H ($m)</th>
<th>L ($m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends paid in the year</td>
<td>250</td>
<td>300</td>
<td>80</td>
</tr>
<tr>
<td>Retained earnings brought forward</td>
<td>328</td>
<td>493</td>
<td>195</td>
</tr>
</tbody>
</table>

Additional information:

(a) Neither H nor L issued new shares since acquisition.

(b) The fair value difference on the subsidiary relates to property, plant and equipment being depreciated through cost of sales over a remaining useful life of ten years from the acquisition date. The fair value difference on the associate relates to non-depreciable land (which has not been sold since acquisition). The tax base of land and property is based on its cost.

(c) Group policy is to measure non-controlling interests at acquisition at fair value. The fair value of the non-controlling interests on 1 July 20X2 was calculated as $188m.

(d) H's intangible assets include $87 million of training and marketing expenditure incurred during the year ended 30 June 20X6. The directors of H believe that these should be capitalised as they relate to the start-up period of a new business venture in Scotland, and intend to amortise the balance over five years from 1 July 20X6. The expenditure was recognised as a tax allowable expense in the year, however, since it was a late management decision to capitalise the training costs, no deferred tax has been provided on the item.

(e) During the year ended 30 June 20X6 H sold goods to Y for $1,300 million. The company makes a profit of 30% on the selling price. $140 million of these goods were held by Y on 30 June 20X6 ($60 million on 30 June 20X5).

(f) Annual impairment tests have indicated impairment losses of $50m relating to the recognised goodwill of H including $25m in the current year. The Y Group recognises impairment losses on goodwill as an operating expense. No impairment losses to date have been necessary for the investment in L.

(g) The tax rate applicable to all group companies is 17%; the conditions in SFRS(I) 1-12 Income Taxes under which entities may offset all deferred tax assets and liabilities are met.
(h) The tax base of the investments in H and L is their cost.
(i) There are no tax consequences of dividends remitted other than corporate income tax charged on profits before the dividends are paid.

Required
Prepare the consolidation schedules necessary to prepare the consolidated statement of profit or loss and other comprehensive income for the year ended 30 June 20X6 for the Y Group and a consolidated statement of financial position at that date.
You should round all workings to the nearest $1,000,000.

1.11 Long-term interests in associates
An investor may have long-term interests in an associate (or joint venture) that form part of the entity’s net investment in the investee but to which the equity method is not applied. For example an investor may have made a long-term loan to an associate. These form part of the carrying amount of the investment in associate.

SFRS(I) 1-28 clarifies that SFRS(I) 9 applies to such long-term interests and in applying SFRS(I) 9, adjustments required by SFRS(I) 1-28 (such as reductions in the carrying amount of the total investment in associate due to the allocation of losses) should be disregarded.

SECTION SUMMARY
The equity method is used to account for associates in the consolidated accounts:
- **Statement of financial position**: investment in associate is measured at cost plus (or minus) the group’s share of the associate’s post-acquisition total comprehensive income.
- **Profit or loss (statement of profit or loss and other comprehensive income)**: include the group’s share of associate’s profit after tax and other comprehensive income after tax.

2 Joint arrangements

SECTION INTRODUCTION
SFRS(I) 11 classifies joint arrangements as either joint operations or joint ventures.

The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.

Joint arrangements are often found when each party can contribute in different ways to the activity. For example, one party may provide finance, another purchases or manufactures goods, while a third offers its marketing skills.

SFRS(I) 11 *Joint Arrangements* covers all types of joint arrangements. It is not concerned with the accounts of the joint arrangement itself (if separate accounts are maintained), but rather how the interest in a joint arrangement is accounted for by each party.
2.1 Definitions

SFRS(I) 11 begins by listing some important definitions.

**KEY TERMS**

<table>
<thead>
<tr>
<th><strong>TERM</strong></th>
<th><strong>DEFINITION</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>JOINT ARRANGEMENT</strong></td>
<td>An arrangement of which two or more parties have joint control.</td>
</tr>
<tr>
<td><strong>JOINT CONTROL</strong></td>
<td>The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.</td>
</tr>
<tr>
<td><strong>JOINT OPERATION</strong></td>
<td>A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement.</td>
</tr>
<tr>
<td><strong>JOINT VENTURE</strong></td>
<td>A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.</td>
</tr>
</tbody>
</table>

2.2 Forms of joint arrangement

SFRS(I) 11 classifies joint arrangements as either joint operations or joint ventures. The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.

A **joint operation** is a joint arrangement whereby the parties that have joint control (the joint operators) have rights to the assets, and obligations for the liabilities, of that joint arrangement. A joint arrangement that is **not structured through a separate entity** is always a joint operation.

A **joint venture** is a joint arrangement whereby the parties that have joint control (the joint venturers) of the arrangement have **rights to the net assets** of the arrangement.

A **joint arrangement** that is structured through a **separate entity** may be either a joint operation or a joint venture. In order to ascertain the classification, the parties to the arrangement should assess the terms of the contractual arrangement together with any other facts or circumstances to assess whether they have:

- Rights to the assets, and obligations for the liabilities, in relation to the arrangement (indicating a joint operation)
- Rights to the net assets of the arrangement (indicating a joint venture)

Detailed guidance is provided in the appendices to SFRS(I) 11 in order to help this assessment, giving consideration to, for example, the wording contained within contractual arrangements.
2.2.1 Contractual arrangement

The existence of a contractual agreement distinguishes a joint arrangement from an investment in an associate. **If there is no contractual arrangement, then a joint arrangement does not exist.** The agreement is the key evidence of shared control.

**Evidence** of a contractual arrangement could be in one of several forms.

- **Contract** between the parties
- **Minutes** of discussion between the parties
- Incorporation in the **articles or by-laws** of the separate vehicle

The contractual arrangement is usually in **writing**, whatever its form, and it will deal with the following issues surrounding the joint arrangement.

- **Its activity, duration and reporting obligations**
- The appointment of its **board of directors** (or equivalent) and the **voting rights** of the parties
- **Capital contributions** to it by the parties
- How its output, income, expenses or results are **shared** between the parties

It is the contractual arrangement which establishes **joint control** over the joint arrangement, so that no single party can control the activity of the joint arrangement on its own.
The terms of the contractual arrangement are key to deciding whether the arrangement is a joint venture or joint operation. SFRS(I) 11 (paragraph B27) includes a table of issues to consider and explains the influence of a range of points that could be included in the contract. The table is summarised below.

<table>
<thead>
<tr>
<th></th>
<th>Joint operation</th>
<th>Joint venture</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The terms of the contractual arrangement</strong></td>
<td>The parties to the joint arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.</td>
<td>The parties to the joint arrangement have rights to the <strong>net assets</strong> of the arrangement (ie it is the separate vehicle, not the parties, that has rights to the assets, and obligations for the liabilities).</td>
</tr>
<tr>
<td><strong>Rights to assets</strong></td>
<td>The parties to the joint arrangement share all interests (eg rights, title or ownership) in the assets relating to the arrangement in a specified proportion (eg in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).</td>
<td>The assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (ie no rights, title or ownership) in the assets of the arrangement.</td>
</tr>
<tr>
<td><strong>Obligations for liabilities</strong></td>
<td>The parties share all liabilities, obligations, costs and expenses in a specified proportion (eg in proportion to their ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).</td>
<td>The joint arrangement is liable for the debts and obligations of the arrangement.</td>
</tr>
<tr>
<td></td>
<td>The parties to the joint arrangement are liable for claims by third parties.</td>
<td>Creditors of the joint arrangement do not have rights of recourse against any party.</td>
</tr>
<tr>
<td><strong>Revenues, expenses, profit or loss</strong></td>
<td>The contractual arrangement establishes the allocation of revenues and expenses on the basis of the relative performance of each party to the joint arrangement. For example, the contractual arrangement might establish that revenues and expenses are allocated on the basis of the capacity that each party uses in a plant operated jointly.</td>
<td>The contractual arrangement establishes each party's share in the profit or loss relating to the activities of the arrangement.</td>
</tr>
<tr>
<td><strong>Guarantees</strong></td>
<td>The provision of guarantees to third parties, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation.</td>
<td></td>
</tr>
</tbody>
</table>
Question 26.2

This question is based on Illustrative example 2 from SFRS(I) 11.

Two real estate companies (the parties) set up a separate vehicle (Supermall) for the purpose of acquiring and operating a shopping centre. The contractual arrangement between the parties establishes joint control of the activities that are conducted in Supermall. The main feature of Supermall’s legal form is that the entity, not the parties, has rights to the assets, and obligations for the liabilities, relating to the arrangement. These activities include the rental of the retail units, managing the car park, maintaining the centre and its equipment, such as lifts, and building the reputation and customer base for the centre as a whole.

The terms of the contractual arrangement are such that:

(a) Supermall owns the shopping centre. The contractual arrangement does not specify that the parties have rights to the shopping centre.
(b) The parties are not liable in respect of the debts, liabilities or obligations of Supermall. If Supermall is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of each party to any third party will be limited to the unpaid amount of that party’s capital contribution.
(c) The parties have the right to sell or pledge their interests in Supermall.
(d) Each party receives a share of the income from operating the shopping centre (which is the rental income net of the operating costs) in accordance with its interest in Supermall.

Required

Explain how Supermall should be classified in accordance with SFRS(I) 11 Joint Arrangements.

2.2.2 Relevant activities

The definition of joint control states that joint control only exists where parties sharing control make decisions about the relevant activities of an entity.

Examples of relevant activities include:

- Approval of business plans and strategy
- Major capital expenditure and asset disposal
- Funding decisions
- Nomination and removal of board members

2.3 Accounting treatment

The accounting treatment depends on whether a joint arrangement is classified as a joint operation or a joint venture.

2.3.1 Accounting for joint operations

SFRS(I) 11 requires that a joint operator recognises line-by-line the following in relation to its interest in a joint operation:

(a) Its assets, including its share of any jointly held assets
(b) Its liabilities, including its share of any jointly incurred liabilities
(c) Its revenue from the sale of its share of the output arising from the joint operation
(d) Its share of the revenue from the sale of the output by the joint operation, and
(e) Its expenses, including its share of any expenses incurred jointly.

Note that (c) refers to output of the joint operation sold by the joint operator itself, whilst (d) refers to output of the joint operation sold by the joint operation.

This treatment is applicable in both the separate and consolidated financial statements of the joint operator.
A party that participates in, but does not have joint control of, a joint operation shall also account for its interest in the same manner as a joint operator if that party has rights to the assets, and obligations for the liabilities, relating to the joint operation.

However, if the party that participates in a joint operation does not have rights to the assets, and obligations for the liabilities, relating to that joint operation, it shall account for its interest in the joint operation in accordance with the SFRS(I)s applicable to that interest.

### 2.3.2 Accounting for the acquisition of a joint operation

The principles of SFRS(I) 3 must be applied on the acquisition of an interest in a joint operation where that joint operation constitutes a business as defined by SFRS(I) 3. Therefore on the acquisition of a joint operation meeting the definition of a business, the joint operator must:

(a) Measure the identifiable assets and liabilities at fair value (or in accordance with SFRS(I) 3);
(b) Recognise acquisition costs in accordance with SFRS(I) 3;
(c) Recognise goodwill for the excess consideration given;
(d) Perform an impairment test for the cash-generating unit to which goodwill is allocated annually.

### Question 26.3

Can you think of examples of situations where this type of joint arrangement (a joint operation) might take place?

### 2.3.3 Accounting for joint ventures

Accounting treatment in the separate financial statements of the venturer has been discussed in Chapter 24 section 2.4.

In the consolidated financial statements, joint ventures must be equity accounted in accordance with the requirements of SFRS(I) 1-28 Investments in Associates and Joint Ventures, as detailed in the first part of this chapter. In the separate financial statements, investment is measured at in accordance with SFRS(I) 1-27

### 2.3.4 Application of SFRS(I) 1-28 to joint ventures

The consolidated statement of financial position is prepared by:

(a) Including the interest in the joint venture at cost plus share of post-acquisition total comprehensive income
(b) Including the group share of the post-acquisition total comprehensive income in group reserves

Therefore when a joint venture is first acquired, the acquisition is recorded at cost in the joint venturer's books by:

**DEBIT** Investment in joint venture **X**
**CREDIT** Cash **X**

To recognise the acquisition of a joint venture.

Subsequently the group share of post-acquisition total comprehensive income is recognised by:

**DEBIT** Investment in joint venture **X**
**CREDIT** Group reserves **X**

To recognise the group share of post-acquisition total comprehensive income of the joint venture.

The consolidated statement of profit or loss and other comprehensive income will include:

(a) The group share of the joint venture's profit or loss for the period
(b) The group share of the joint venture's other comprehensive income for the period.
The use of the equity method should be discontinued from the date on which the investment ceases to be an associate or a joint venture.

2.3.5 Transactions between a joint venturer and a joint venture

Both upstream and downstream transactions between venturer and the joint venture are accounted for in the same way as transactions between associate and parent covered in Section 1.5 of this chapter.

Question 26.4 C Ltd (1)

C Ltd undertakes a 50: 50 joint venture with Y Ltd. C Ltd sells inventories with a cost of $2m to the venture.

The fair value of the inventories at the transfer date is estimated at $2.5 million. What amount does C Ltd recognise in its financial statements in respect of the transfer?

Question 26.5 C Ltd (2)

How would this differ if the fair value of the inventories at the transfer date were $1.8 million?

SECTION SUMMARY

- Joint arrangements are classified as either joint operations or joint ventures.
- A contractual arrangement must exist which establishes joint control.
- Joint control is important: one operator must not be able to control the joint arrangement alone.
- Joint operations are accounted for by including the investor's share of assets, liabilities, income and expenses as per the contractual arrangement.
- Joint ventures are accounted for using the equity method as under SFRS(I) 1-28.
**Chapter Roundup**

**SFRS(I) 1-28**
*Investments in Associates and Joint Ventures*

- **Equity method**
  - **Statement of financial position**
    - Investment in associate measured at:
      - Cost
      - \(+/-\) group share of post-acquisition total comprehensive income
  - **Statement of profit or loss and other comprehensive income**
    - Include group share of associate's profit/other comprehensive income after tax

**SFRS(I) 11**
*Joint Arrangements*

- **Contractual agreement**
  - **Joint arrangement**
    - **Joint venture**
      - Joint control
    - **Joint operation**
      - Include investor's share of:
        - Assets
        - Liabilities
        - Income
        - Expenses
Quick Quiz

1. What level of shareholding is presumed to result in significant influence?
2. How is an associate presented in the consolidated statement of profit or loss and other comprehensive income?
3. What is an upstream transaction?
4. A joint venture is a joint arrangement whereby the parties that have ______________ of the arrangement have rights to the ______________ of the arrangement.
   Complete the blanks.
5. What forms of evidence of a contractual agreement might exist?
6. How should an investor account for its share of a joint operation?
7. How should a venturer account for its share of a joint venture?
8. A joint arrangement that is structured through a separate vehicle will always be a joint venture. True or false?
Answers to Quick Quiz

1. Twenty per cent or more
2. The group share of the associate's profit after tax and other comprehensive income after tax is included.
3. Sales from the associate or joint venture to the investor.
4. A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.
5. • Written contract
   • Minutes of discussion
   • Incorporation in the articles/by-laws
6. (a) The assets it controls and the liabilities it incurs
    (b) The expenses it incurs and the income it earns
7. A joint venture is accounted for using the equity method as required by SFRS(I) 1-28 Investments in Associates and Joint Ventures.
8. False. Joint arrangements that are structured through a separate vehicle may be either joint ventures or joint operations. The classification will depend on whether the investor has rights to the net assets of the arrangement. This will depend on the terms of the contractual arrangements.
### Answers to Questions

#### 26.1 Group accounting with deferred tax

**Y GROUP**

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X6**

<table>
<thead>
<tr>
<th></th>
<th>Y</th>
<th>H</th>
<th>Total (W2)</th>
<th>(W3)</th>
<th>(W4)</th>
<th>(W5)</th>
<th>(W6)</th>
<th>(W7)</th>
<th>(W8)</th>
<th>(W9)</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PPE</strong></td>
<td>1,012</td>
<td>920</td>
<td>1,932</td>
<td>(40)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,992</td>
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<tr>
<td><strong>Intangible assets</strong></td>
<td>350</td>
<td>350</td>
<td>(87)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>263</td>
</tr>
<tr>
<td><strong>Invt in H</strong></td>
<td>765</td>
<td>–</td>
<td>765</td>
<td>(765)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>–</td>
</tr>
<tr>
<td><strong>Invt in L</strong></td>
<td>203</td>
<td>–</td>
<td>203</td>
<td>(203)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>–</td>
</tr>
<tr>
<td><strong>Invt in Ass</strong></td>
<td>–</td>
<td>–</td>
<td>170</td>
<td>(25)</td>
<td>(25)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>120</td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
<td>–</td>
<td>–</td>
<td>–</td>
<td></td>
<td></td>
<td>–</td>
<td>170</td>
<td>(25)</td>
<td>(25)</td>
<td></td>
<td>120</td>
</tr>
<tr>
<td><strong>Inv't in H</strong></td>
<td>765</td>
<td>–</td>
<td>765</td>
<td>–</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>–</td>
</tr>
<tr>
<td><strong>Inv't in L</strong></td>
<td>203</td>
<td>–</td>
<td>203</td>
<td>–</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>–</td>
</tr>
<tr>
<td><strong>Inv't in Ass</strong></td>
<td>–</td>
<td>–</td>
<td>170</td>
<td>(25)</td>
<td>(25)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>120</td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
<td>–</td>
<td>–</td>
<td>–</td>
<td></td>
<td></td>
<td>–</td>
<td>170</td>
<td>(25)</td>
<td>(25)</td>
<td></td>
<td>120</td>
</tr>
<tr>
<td><strong>Sh capital</strong></td>
<td>1,200</td>
<td>540</td>
<td>1,740</td>
<td>(540)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,200</td>
</tr>
<tr>
<td><strong>Retained earnings</strong></td>
<td>1,128</td>
<td>809</td>
<td>1,937</td>
<td>(120)</td>
<td>(20)</td>
<td>(20)</td>
<td>123.2</td>
<td>60</td>
<td>(32)</td>
<td>5.4</td>
<td>37</td>
</tr>
<tr>
<td><strong>Reval surplus</strong></td>
<td>142</td>
<td>70</td>
<td>212</td>
<td>(40)</td>
<td>(5)</td>
<td>(1)</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td>168</td>
</tr>
<tr>
<td><strong>NCI</strong></td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>188</td>
<td>(5)</td>
<td>(5)</td>
<td>79.6</td>
<td>124.2</td>
<td>(8)</td>
<td>1.4</td>
<td>1.4</td>
</tr>
<tr>
<td><strong>Deferred tax</strong></td>
<td>100</td>
<td>50</td>
<td>150</td>
<td>(6.8)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>73.1</td>
</tr>
<tr>
<td><strong>Payables</strong></td>
<td>1,880</td>
<td>2,300</td>
<td>4,180</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>4,180</td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>900</td>
<td>510</td>
<td>1,410</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,410</td>
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<tr>
<td><strong>2,470</strong></td>
<td>4,450</td>
<td>3,769</td>
<td>8,219</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>7,524</td>
</tr>
<tr>
<td><strong>Revenue</strong></td>
<td>4,480</td>
<td>4,200</td>
<td>8,680</td>
<td>(1,300)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>7,380</td>
</tr>
<tr>
<td><strong>Cost of sales</strong></td>
<td>(2,690)</td>
<td>(2,940)</td>
<td>(5,630)</td>
<td>10</td>
<td>18</td>
<td>(42)</td>
<td>1,300</td>
<td></td>
<td></td>
<td></td>
<td>(4,364)</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>1,790</td>
<td>1,260</td>
<td>3,050</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3,016</td>
</tr>
<tr>
<td><strong>Op expenses</strong></td>
<td>(620)</td>
<td>(290)</td>
<td>(910)</td>
<td>(25)</td>
<td>(87)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(1,022)</td>
</tr>
<tr>
<td><strong>Finance costs</strong></td>
<td>(50)</td>
<td>(80)</td>
<td>(130)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(130)</td>
</tr>
<tr>
<td><strong>Share of profit of ass.</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>37</td>
</tr>
<tr>
<td><strong>Dividend income</strong></td>
<td>260</td>
<td>–</td>
<td>260</td>
<td>(240)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(20)</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>1,380</td>
<td>890</td>
<td>2,270</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,901</td>
</tr>
<tr>
<td><strong>Income tax</strong></td>
<td>(330)</td>
<td>(274)</td>
<td>(604)</td>
<td>1.7</td>
<td>4</td>
<td>(68.6)</td>
<td>666.9</td>
<td></td>
<td></td>
<td></td>
<td>1,234.1</td>
</tr>
<tr>
<td><strong>Profit for year</strong></td>
<td>1,050</td>
<td>616</td>
<td>1,666</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,262.1</td>
</tr>
<tr>
<td><strong>OCI – not reclassified:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Gain on revaluation</strong></td>
<td>30</td>
<td>7</td>
<td>37</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>37</td>
</tr>
<tr>
<td><strong>OCI of associate</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2</td>
</tr>
<tr>
<td><strong>Tax on OCI</strong></td>
<td>(9)</td>
<td>(2)</td>
<td>(11)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(11)</td>
</tr>
<tr>
<td><strong>OCI net of tax</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TCI for year</strong></td>
<td>1,071</td>
<td>621</td>
<td>1,692</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,262.1</td>
</tr>
<tr>
<td><strong>Profit att to:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Owners of Y</strong></td>
<td>1,050</td>
<td>493</td>
<td>(20)</td>
<td>(240)</td>
<td>(8)</td>
<td>1.4</td>
<td>(70)</td>
<td>14.4</td>
<td>(33.6)</td>
<td>3.2</td>
<td>37</td>
</tr>
<tr>
<td><strong>NCI (20%)</strong></td>
<td>123</td>
<td>(5)</td>
<td>(2)</td>
<td>0.3</td>
<td>(17)</td>
<td>3.6</td>
<td>(8.4)</td>
<td>0.8</td>
<td></td>
<td></td>
<td>95.3</td>
</tr>
</tbody>
</table>
The profit and TCI of H Ltd have been allocated to the owners of Y and the NCI in accordance with ownership interests in the second column of the schedule.

**Workings (all to nearest million)**

1. **Group structure**

   \[
   \begin{array}{c|c|c|c|c}
   \text{Y} & \text{H} & \text{Total} & \text{Consolidated} \\
   \text{W2(iii)} & \text{W4(ii)} & \text{W5(i)} & \text{W7(iii)} & \text{W7(i)} & \text{W8(ii)} & \text{W9} \\
   \text{m} & \text{m} & \text{m} & \text{m} & \text{m} & \text{m} & \text{m} \\
   \hline
   \text{TCI att to:} & 1,071 & 497 & (20) & (240) & (8) & 1.4 & (70) & 14.4 & (33.6) & 3.2 & (20) & (68.6) & 1,165.8 \\
   \text{Owners of Y} & (ii) & (W3(ii)) & 124 & (5) & (2) & 0.3 & 17 & 3.6 & (8.4) & 0.8 & & & 96.3 \\
   \text{NCI (20%)} & & & & & & & & & & & & & \\
   \hline
   \end{array}
   \]

2. **Goodwill**

   (i) **Goodwill on acquisition of H**

   \[
   \begin{align*}
   \text{Consideration transferred} & \quad 765 \\
   \text{Fair value of non-controlling interests} & \quad 188 \\
   \text{Fair value of net assets acquired:} & \\
   \text{Share capital} & \quad 540 \\
   \text{Retained earnings at acq'n} & \quad 120 \\
   \text{Revaluation surplus at acq'n} & \quad 40 \\
   \text{Fair value adjustment (property)} & \quad 100 \\
   \text{Deferred tax liability arising on fair value adjustment (note)} & \quad (17) \\
   \text{Total FV of net assets} & \quad (783) \\
   \text{Goodwill} & \quad 170
   \end{align*}
   \]

**Notes:**

1. A deferred tax liability arises in respect of the fair value adjustment since this results in the carrying amount of the property exceeding its tax base (cost).
2. Goodwill attributable to the NCI is $188m – (20% \times $783m) = $31.4m
3. Deferred tax does not arise on the recognition of goodwill itself, in accordance with SFRS(I) 1-12 Income Taxes (paragraph 15).

**Therefore (in $):**

- **DEBIT** Goodwill 170,000,000
- **DEBIT** Share capital 540,000,000
- **DEBIT** Retained earnings 120,000,000
- **DEBIT** Revaluation surplus 40,000,000
- **DEBIT** Property, plant and equipment 100,000,000
- **CREDIT** Deferred tax liability 17,000,000
- **CREDIT** Cost of investment 765,000,000
- **CREDIT** NCI 188,000,000

To eliminate the share capital and reserves of H at acquisition against the cost of investment and recognise the NCI and goodwill.
Goodwill impairment

Goodwill is impaired by $25m at the start of the period. As goodwill is 'full goodwill' and part attributable to the NCI, the impairment loss is allocated between group retained earnings and the NCI in proportion to ownership interests ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Retained earnings (80%)</th>
<th>20,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit</td>
<td>NCI (20%)</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Credit</td>
<td>Goodwill</td>
<td>25,000,000</td>
</tr>
</tbody>
</table>

to recognise the cumulative impairment of goodwill

A $25,000 impairment arises in the year and is recognised by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Operating expenses</th>
<th>25,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit</td>
<td>Goodwill</td>
<td>25,000,000</td>
</tr>
</tbody>
</table>

The impairment loss is allocated between the owners of Y and the NCI in both the consolidated statement of profit or loss and other comprehensive income and the consolidated statement of financial position (equity section):

Owners of Y 80% × $25,000,000 = $20,000,000
NCI 20% × $25,000,000 = $5,000,000

Allocation of increase in retained reserves since acquisition to NCI

(i) At the start of the period

<table>
<thead>
<tr>
<th></th>
<th>At start of period</th>
<th>At acquisition</th>
<th>Increase</th>
<th>NCI share (20%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
</tr>
<tr>
<td>of H</td>
<td>493 (given)</td>
<td>120</td>
<td>373</td>
<td>74.6</td>
</tr>
<tr>
<td>Revaluation surplus</td>
<td>(70 – 5) = 65</td>
<td>40</td>
<td>25</td>
<td>5</td>
</tr>
</tbody>
</table>

Therefore ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Retained earnings</th>
<th>74,600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit</td>
<td>Revaluation surplus</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Credit</td>
<td>NCI</td>
<td>79,600,000</td>
</tr>
</tbody>
</table>

to allocate post-acquisition reserves movements up to the start of the current period to the NCI

(ii) Profit and OCI arising in the year

<table>
<thead>
<tr>
<th></th>
<th>Total $m</th>
<th>NCI (20%) $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit of H</td>
<td>616</td>
<td>123.2</td>
</tr>
<tr>
<td>Revaluation surplus</td>
<td>5</td>
<td>1.0</td>
</tr>
</tbody>
</table>

Therefore ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Retained earnings</th>
<th>123,200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit</td>
<td>Revaluation surplus</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Credit</td>
<td>NCI</td>
<td>124,200,000</td>
</tr>
</tbody>
</table>

to allocate profit and OCI of the current period to the NCI in the consolidated statement of financial position

Note that these amounts are reflected in the allocation of profits and OCI to the NCI as stated in the consolidated statement of profit or loss and other comprehensive income.
4 **Dividend paid by H**

The dividend paid in the year by H of $300m is eliminated against the dividend income recognised by Y (80%) and the NCI (20%) in H by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend income (SPLOCI)</td>
<td>Retained earnings</td>
<td>240,000,000</td>
</tr>
<tr>
<td>Dividend income (SFP)</td>
<td></td>
<td>60,000,000</td>
</tr>
<tr>
<td>NCI</td>
<td></td>
<td>300,000,000</td>
</tr>
</tbody>
</table>

The debit entry in the SPLOCI is allocated to the owners of Y.

In the consolidated statement of financial position, the debit entry in respect of dividend income is accumulated in retained earnings; therefore a net credit entry of $60,000,000 is made to retained earnings.

5 **Depreciation of fair value uplift to property**

(i) The acquisition date fair value uplift of $100m is depreciated over ten years since acquisition. Therefore at the reporting date a cumulative 4/10 years \( \times \) $100m = $40m must be recognised. This is allocated between group retained earnings and the NCI in proportion to ownership interests.

Adjustment is made to the consolidated statement of financial position by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings (80%)</td>
<td>Property, plant and equipment</td>
<td>32,000,000</td>
</tr>
<tr>
<td>NCI (20%)</td>
<td></td>
<td>8,000,000</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td></td>
<td>40,000,000</td>
</tr>
</tbody>
</table>

(ii) The depreciation expense for the year included within the cumulative $40m is $10m. This is recognised in cost of sales and allocated between the Group and the NCI in the ratio 80:20.

(iii) The carrying amount of the fair value uplift at the reporting date is $60m, therefore the associated deferred tax liability is $60m \( \times \) 17% = $10.2m. This is a reduction of $6.8m since the acquisition date. This is recognised by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax liability</td>
<td>Retained earnings (80%)</td>
<td>6,800,000</td>
</tr>
<tr>
<td>NCI (20%)</td>
<td></td>
<td>5,400,000</td>
</tr>
<tr>
<td>NCI (20%)</td>
<td></td>
<td>1,400,000</td>
</tr>
</tbody>
</table>

(iv) The deferred tax liability at the start of the period was $70m \( \times \) 17% = $11.9m and therefore the reduction in the deferred tax liability for the year included within the cumulative $7 million is $1.7 million ($11.9m – $10.2m) This is recognised in the income tax expense and allocated between the Group and the NCI in the ratio 80:20.

6 **Intangible assets**

The subsidiary, H has incorrectly capitalised intangible assets of $87 million during the year. This entry must be reversed and the cost written off to profit or loss. This is achieved by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating expenses</td>
<td>Intangible assets</td>
<td>87,000,000</td>
</tr>
</tbody>
</table>

The additional operating expenses are allocated between the owners of Y and the NCI in both the consolidated statement of profit or loss and other comprehensive income and the consolidated statement of financial position (equity section):

| Owners of Y | 80% \( \times \) $87,000,000 | = | $70,000,000 |
| NCI          | 20% \( \times \) $87,000,000  | = | $17,000,000 |
7  Intragroup trading

(i)  The intragroup sale of goods in the year must be eliminated by ($):

DEBIT Revenue 1,300,000,000
CREDIT Cost of sales 1,300,000,000

to eliminate the intragroup sale of goods

In addition adjustment is required for both the opening and closing provisions for unrealised
profits. Since a deductible timing difference arises in respect of unrealised profits at a
period end, adjustment is also required for deferred tax.

(ii) Adjustment is required for the opening provision for unrealised profit of $60m \times 30% = $18m by ($):

DEBIT Retained earnings (80%) 14,400,000
DEBIT NCI (20%) 3,600,000
CREDIT Cost of sales 18,000,000

to recognise the opening provision for unrealised profit in retained earnings/the NCI brought
forward and its reversal in current year cost of sales

The credit entry to cost of sales is allocated between the owners of Y (80%) and the NCI
(20%). The net effect of this adjustment in the consolidated statement of financial position
is therefore nil.

(iii) Adjustment is also required for the closing provision for unrealised profits of $140m \times 30% = $42m by ($):

DEBIT Cost of sales 42,000,000
CREDIT Inventory 42,000,000

to adjust for the closing unrealised profit in inventory

The debit entry to cost of sales is allocated between the owners of Y (80%) ($33.6m) and
the NCI (20%) ($8.4m) and accumulated in the consolidated statement of financial
position (equity)

(iv) The deferred tax asset arising on the period end unrealised profit is $42m \times 17% = $7.1m. Of this, $3.1m ($18m \times 17%) existed at the previous year end. The movement of
$4m is recognised as part of the income tax charge for the year; the brought forward
amount is credited to group reserves and the NCI by ($):

DEBIT Deferred tax asset 7,100,000
CREDIT Income tax charge (SPLOCI) 4,000,000
CREDIT Retained earnings (80% \times 3.1m) 2,500,000
CREDIT NCI (20% \times $3.1m) 600,000

to recognise deferred tax on the unrealised profit

The credit to the income tax charge is allocated between the owners of Y and the NCI and
accumulated in retained earnings/the NCI in net assets such that the total credit entry to
retained earnings is $7.1m \times 80% = $5.7m and the total credit entry to the NCI in net
assets is $7.1m \times 20% = $1.4m as a result of this journal.

The deferred tax asset is netted off with the liability in the consolidated statement of
financial position as all SFRS(I) 1-12 conditions are met.
8 Investment in Associate

L is an associate and equity accounting must be applied. Therefore:

(i) The investment is reclassified in the consolidated statement of financial position as an investment in associate by ($):

```
DEBIT Investment in associate 203,000,000
CREDIT Investment in L 203,000,000
```

to reclassify the investment as an associate

(ii) The group share of profits and OCI earned in the year by L are recognised in the consolidated statement of profit or loss and other comprehensive income and increase the carrying amount of the investment. No adjustment is required in respect of the fair value uplift to the land as this is a non-depreciable asset. The required entry is ($):

```
DEBIT Investment in associate 39,000,000
CREDIT Income from associate ($148m \times 25\%) 37,000,000
CREDIT Other comprehensive income from associate ($8m \times 25\%) 2,000,000
```

to recognise total comprehensive income of the associate

Income from the associate is accumulated in group retained earnings; other comprehensive income (a revaluation) is accumulated in the group revaluation surplus.

(iii) The dividend received from the associate is eliminated against the investment in associate by ($):

```
DEBIT Dividend income 20,000,000
CREDIT Investment in associate 20,000,000
```

to eliminate dividend income from the associate against its carrying amount

The debit entry is accumulated in retained earnings in the consolidated statement of financial position.

9 Deferred tax arising on investments

Deferred tax arises on the investment in the associate because the SFRS(I) 1-12 criteria that must be met in order to avoid recognising deferred tax are not met. This is evidenced by the fact that Y does not have an agreement requiring that the profits of the associate will not be distributed in the near future (SFRS(I) 1-12 paragraph 42).

The temporary difference is calculated as the difference between the tax base of the investment in L (its cost) and the carrying amount in the consolidated SOFP:

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount</td>
<td>(203m + $39m – $20m) 222,000</td>
</tr>
<tr>
<td>Cost</td>
<td>(203,000)</td>
</tr>
<tr>
<td>Taxable temporary difference</td>
<td>19,000</td>
</tr>
</tbody>
</table>

Deferred tax also arises on the investment in the subsidiary because, although Y can control the timing of the reversal of the temporary difference, it is not probable that the temporary difference will not reverse in the foreseeable future. This is evidenced by the fact that H pays an annual dividend.

The temporary difference is calculated as the difference between the tax base of the investment in H (its cost) and the carrying amount in the consolidated SOFP:

<table>
<thead>
<tr>
<th></th>
<th>30 June 20X5</th>
<th>30 June 20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Cost</td>
<td>(765,000)</td>
<td>(765,000)</td>
</tr>
<tr>
<td>Taxable temporary difference</td>
<td>26,600</td>
<td>411,100</td>
</tr>
</tbody>
</table>
### Carrying amount of subsidiary at reporting date:

<table>
<thead>
<tr>
<th></th>
<th>20X5 working</th>
<th>30 June 20X5</th>
<th>20X6 working</th>
<th>30 June 20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Net assets as</td>
<td>(1,419 – 621)</td>
<td>798.0</td>
<td>1,419.0</td>
<td></td>
</tr>
<tr>
<td>reported by H</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fair value uplift to</td>
<td>(100 – 30)</td>
<td>70.0</td>
<td>60.0</td>
<td></td>
</tr>
<tr>
<td>PPE – carrying</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>amount</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Write off of</td>
<td>–</td>
<td></td>
<td>(87.0)</td>
<td></td>
</tr>
<tr>
<td>intangible assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Elimination of</td>
<td>(18.0)</td>
<td></td>
<td>(42.0)</td>
<td></td>
</tr>
<tr>
<td>unrealised profit</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(W7)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax (W5)</td>
<td>(11.9 – 3.1)</td>
<td>(8.8)</td>
<td>(17 – 6.8 – 7.1)</td>
<td>(3.1)</td>
</tr>
<tr>
<td>and (W7)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>(170 – 25)</td>
<td>145.0</td>
<td>120.0</td>
<td></td>
</tr>
<tr>
<td>NCI</td>
<td>($841.2m × 20%)</td>
<td>31.4 (W2) –</td>
<td>(194.6)</td>
<td>(290.8)</td>
</tr>
<tr>
<td></td>
<td>+ 31.4 (W2) –</td>
<td>(W5) – (W7) –</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>($25m impairment × 20%)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(194.6)</td>
<td>(290.8)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>841.2</td>
<td>(17 – 6.8 – 7.1)</td>
<td>(3.1)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>1,346.9</td>
<td></td>
</tr>
<tr>
<td></td>
<td>791.6</td>
<td></td>
<td></td>
<td>1,176.1</td>
</tr>
</tbody>
</table>

The total taxable temporary difference at the reporting date is therefore $19m + $411.1m, and the related deferred tax liability is $430.1 × 17% = $73.1m.

The taxable temporary difference at the start of the period related to the subsidiary only and was $26.6m resulting in a deferred tax liability of $26.6m × 17% = $4.5m. The increase in the liability of $68.6m is recognised as part of the income tax charge for the year.

Therefore the required journal entry is ($):

**DEBIT** Income tax (SPLOCI) 68,600,000

**DEBIT** Retained earnings 4,500,000

**CREDIT** Deferred tax liability 73,100,000

**to recognise deferred tax arising on the investments**

The tax charge is allocated to the parent company only and is accumulated in retained earnings making a total debit entry of $73.1m.

### 26.2 Joint arrangement

Supermall has been set up as a **separate vehicle**. As such, it could be either a joint operation or joint venture, so other facts must be considered.

There are no facts that suggest that the two real estate companies have rights to substantially all the benefits of the assets of Supermall nor an obligation for its liabilities.

Each party's liability is limited to any unpaid capital contribution.

As a result, each party has an interest in the **net assets** of Supermall and should account for it as a **joint venture** using the **equity method**.

### 26.3 Joint operations

SFRS(I) 11 gives examples in the oil, gas and mineral extraction industries. In such industries companies may, say, jointly control and operate an oil or gas pipeline. Each company transports its own products down the pipeline and pays an agreed proportion of the expenses of operating the pipeline (perhaps based on volume). In this case the parties have rights to assets (such as exploration permits and the oil or gas produced by the activities).
A further example is a property which is jointly controlled, each joint operator taking a share of the rental income and bearing a portion of the expense.

26.4  C Ltd (1)

C Ltd has made a profit of $500,000, but only half of this can be considered as realised (ie the part attributable to the other venturer). C Ltd therefore recognises a gain of $250,000.

26.5  C Ltd (2)

Here a loss of $200,000 is made. C Ltd is required to recognise this in full immediately as it represents a reduction in the net realisable value of the inventories.
This chapter introduces the first of several more complicated consolidation topics. The best way to tackle complex groups is to be logical and to carry out the consolidation on a step by step basis.
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group Accounting</td>
<td>3</td>
</tr>
<tr>
<td>Apply the method of accounting for business combinations including the</td>
<td></td>
</tr>
<tr>
<td>accounting for non-controlling interests.</td>
<td>3</td>
</tr>
<tr>
<td>Determine and apply appropriate consolidation procedures to be used in</td>
<td></td>
</tr>
<tr>
<td>preparing group financial statements, including statements of cash flows.</td>
<td></td>
</tr>
</tbody>
</table>

Syllabus Handbook

1 Complex groups

SECTION INTRODUCTION

A parent company may have several subsidiaries, including sub-subsidiaries which are held indirectly through direct subsidiaries.

1.1 Introduction

In this section we shall consider how the principles of statement of financial position consolidation may be applied to more complex structures of companies within a group.

(a) Several subsidiary companies

![Diagram showing P holding 80% in S1 and 60% in S2]

You have already seen this type of structure in your previous studies.

(b) Sub-subsidiaries

![Diagram showing P holding 80% in S, which holds 75% in SS]

P holds a controlling interest in S which in turn holds a controlling interest in SS. SS is therefore a subsidiary of a subsidiary of P, in other words, a sub-subsidiary of P.
(c) **Direct holdings in sub-subsidiaries: ‘D’ shaped groups**

In this example, SS is a sub-subsidiary of P with additional shares held directly by P.

In practice, groups are usually larger, and therefore more complex, but the procedures for consolidation of large groups will not differ from those we shall now describe for smaller ones. The basic principles relating to consolidation still apply (see Chapter 25).

### 1.2 A parent company which has several subsidiaries

Where a company P has several subsidiaries S₁, S₂, S₃ and so on, the technique for consolidation is exactly as previously described. **Elimination** is from the holding company, which has assets of investments in subsidiaries S₁, S₂, S₃, to each of the several subsidiaries.

The consolidated statement of financial position will show:

- A single figure for **non-controlling interest**; and
- A single figure for **goodwill** arising.

### 1.3 Sub-subsidiaries

A slightly different problem arises when there are sub-subsidiaries in the group, which is how should we **identify the non-controlling interest** in the retained earnings of the group? Suppose P owns 80% of the equity of S, and that S in turn owns 60% of the equity of SS:

<table>
<thead>
<tr>
<th>Ownership</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owned by P (80% × 60%)</td>
<td>48</td>
</tr>
<tr>
<td>Owned by the NCI in S (20% × 60%)</td>
<td>12</td>
</tr>
<tr>
<td>Owned by the NCI in SS</td>
<td>40</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Therefore the total NCI ownership is 52%, and this percentage is used for the purposes of calculating goodwill, the NCI and reserves in the consolidated financial statements. Notwithstanding that P’s effective shareholding in SS is 48%, it is still consolidated as a subsidiary because P has control over S, which controls SS.
However, where P acquires S before S acquires SS, the acquisition of SS can be viewed in one of two ways:

(a) The group has acquired 60% of SS, or
(b) P has acquired $80\% \times 60\% = 48\%$ of SS.

Therefore the ownership of SS for the purpose may be calculated in either of the following ways:

|          | (a) Owned by the group | %  | (b) Owned by P (80\% \times 60\%) | %  
|----------|------------------------|----|----------------------------------|----
| Owned by the group | 60                     |    | Owned by NCI in S (20\% \times 60\%) | 12  
| Owned by NCI in SS | 40                     |    | Owned by NCI in SS               | 40  
| 100       | 100                    |    | 100                              | 100 |

Under method (a), the total NCI ownership is 40%; under (b), the total NCI ownership is 52%. Whichever method is used, the appropriate percentage is used in the preparation of the consolidated financial statements.

You should note that neither method is correct or incorrect; SFRS(I) 10 does not specify how the NCI is calculated, and the variation arises depending on how the requirements of the standard are applied.

Within the examples in this chapter, solutions will be based on first one method and then the other. For the purposes of your examination, either method will be marked correctly.

Regardless of which way the acquisition of SS is viewed (where it is acquired after S):

- Its assets and liabilities are consolidated in full.

Question 27.1

Top Co acquired 60% of the equity of Middle Co, which already owned 75% of the equity of Bottom Co. What is Top Co's interest in Bottom Co?

1.4 Date of effective control

The date the sub-subsidiary comes under the control of the holding company is either:

(a) The date P acquired S if S already holds shares in SS; or
(b) If S acquires shares in SS later, then that later date.

You need to think about the dates of acquisition and the order in which the group is built up when you identify which balances to select as the pre-acquisition reserves of the sub-subsidiary. As we have seen, the date of acquisition of the sub-subsidiary is also important when determining the non-controlling interest.

SECTION SUMMARY

When a holding company has several subsidiaries, the consolidated statement of financial position shows a single figure for non-controlling interests and for goodwill arising on consolidation. In cases where there are several subsidiaries the technique is to propose a consolidation worksheet to compute a single non-controlling interest working and a single goodwill working.
2 Consolidating sub-subsidiaries

SECTION INTRODUCTION

When dealing with sub-subsidiaries, consolidation procedures are more complex.

The basic consolidation overview is as follows:

(a) **Net assets**: show what the group controls (ie P’s net assets + S’s net assets + SS’s net assets).

(b) **Equity (capital and reserves)**: show who owns the net assets included elsewhere in the statement of financial position. Reserves (retained earnings), therefore, are based on effective shareholdings.

The basic steps are exactly as you have seen in simpler group structures (eliminate cost of investment and compute goodwill). As you will see in the examples that follow in this chapter, there are some new complications to be aware of in the workings for **goodwill** and **non-controlling interests** (such as calculating the effective ownership by the group and the NCI as we saw above in section 1).

2.1 Methods of consolidation

There are two methods of consolidating financial statements of complex groups, namely the Consolidation of Consolidation method and the Indirect Interest method.

(a) **Consolidation of Consolidation method** (also known as Direct Consolidation, Sequential Consolidation or Consolidation in Stages). This method is commonly used in practice especially for large complex groups of companies where the subsidiary company will first consolidate the sub-subsidiaries within its own group followed by the ultimate parent consolidating the consolidated financial statements of the subsidiary. This method simplifies the consolidation process for the parent company as it simply consolidates the already consolidated accounts of the subsidiary and sub-subsidiaries.

(b) **Indirect Interest method** also known as Simultaneous Consolidation or One Stage Consolidation is much faster compared to the consolidation of consolidation method and is only suitable for simple and less complex groups as well as for examination purposes due to time constraint. By applying this method, the parent will consolidate its subsidiary and sub-subsidiary at the same time.

2.2 Date of acquisition

Care must be taken when consolidating sub-subsidiaries, because (usually) either:

(a) The parent company acquired the subsidiary after the subsidiary bought the sub-subsidiary; or

(b) The parent company acquired the subsidiary before the subsidiary bought the sub-subsidiary.

Depending on whether (a) or (b) is the case, the retained earnings of the subsidiary at acquisition will be different.
### Sub-subsidiary acquired first

<table>
<thead>
<tr>
<th>Timeline</th>
<th>Reporting Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>P takes control of S</td>
<td>On Reporting Date, on P's consolidated financial statements, P's reserves comprise:</td>
</tr>
<tr>
<td>S takes control of SS</td>
<td>(a) P's own reserves</td>
</tr>
<tr>
<td></td>
<td>(b) P's effective interest share of changes in S's reserves from the date P acquires S</td>
</tr>
<tr>
<td></td>
<td>(c) P's effective interest share of changes in SS's reserves from the date P acquires S</td>
</tr>
</tbody>
</table>

On Reporting Date, NCI amount on reporting date will be NCI's share of equity when P takes control of SS and its share of changes until reporting date.

The rule to remember, when considering pre- and post-acquisition profits, is that we are only interested in the consolidated results of the **parent company**.

### Subsidiary acquired first

<table>
<thead>
<tr>
<th>Timeline</th>
<th>Reporting Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>P takes control of S</td>
<td>On Reporting Date, on P's consolidated financial statements, P's reserves comprise:</td>
</tr>
<tr>
<td>S takes control of SS</td>
<td>(a) P's own reserves</td>
</tr>
<tr>
<td></td>
<td>(b) P's effective interest share of changes in S's reserves from the date P acquires S</td>
</tr>
<tr>
<td></td>
<td>(c) P's effective interest share of changes in SS's reserves from the date S acquires SS</td>
</tr>
</tbody>
</table>

NCI amount on reporting date will be NCI's share of equity when P takes control of S and its share of changes until reporting date.

The best way to understand this is through examples, and therefore the remainder of this section of the chapter is based on examples showing the application of the consolidation method in different circumstances.

### 2.3 Sub-subsidiary acquired first

As we saw in section 1.3, where the sub-subsidiary is already owned by the subsidiary on the date on which the parent acquires the subsidiary, the non-controlling interest in the sub-subsidiary is always based on the parent's effective holding in that company.
**Example**

### Sub-subsidiary acquired first

The draft statements of financial position of P Co, S Co and SS Co on 30 June 20X7 were as follows.

<table>
<thead>
<tr>
<th></th>
<th>P Co</th>
<th>S Co</th>
<th>SS Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tangible assets</td>
<td>105,000</td>
<td>125,000</td>
<td>180,000</td>
</tr>
<tr>
<td>Investments, at cost</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>80,000 of 100,000 shares in S Co</td>
<td>120,000</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>60,000 of 100,000 shares in SS Co</td>
<td>–</td>
<td>110,000</td>
<td>–</td>
</tr>
<tr>
<td>Current assets</td>
<td>80,000</td>
<td>70,000</td>
<td>60,000</td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>80,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>195,000</td>
<td>170,000</td>
<td>115,000</td>
</tr>
<tr>
<td>Payables</td>
<td>30,000</td>
<td>35,000</td>
<td>25,000</td>
</tr>
</tbody>
</table>

- S Co acquired its shares in SS Co on 1 July 20X4 when the reserves of S Co stood at $50,000; and
- P Co acquired its shares in S Co on 1 July 20X5 when the reserves of S Co stood at $40,000 and the reserves of SS Co were $60,000.

It is the group's policy to measure the non-controlling interest at acquisition at its proportionate share of the fair value of the subsidiary's identifiable net assets acquired.

**Required**

Prepare the draft consolidated statement of financial position of P Group at 30 June 20X7.

**Solution**

Here, SS Co only became part of the P group on 1 July 20X5, not on 1 July 20X4. This means that only the retained earnings of SS Co arising after 1 July 20X5 can be included in the post-acquisition reserves of P Co group. Goodwill arising on the acquisition will be calculated by comparing P's share of S's cost of the investment by S in SS to the effective group interests acquired represented by the share capital of SS and its retained earnings at the date P acquired S (here $60,000). The solution presented here uses the indirect interest method.

P CO

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X7**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td></td>
</tr>
<tr>
<td><strong>Non-current assets</strong></td>
<td></td>
</tr>
<tr>
<td>Tangible</td>
<td>410,000</td>
</tr>
<tr>
<td>Goodwill (W2)</td>
<td>19,200</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td>210,000</td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td>639,200</td>
</tr>
<tr>
<td>Ordinary share capital (80,000 shares fully paid)</td>
<td>80,000</td>
</tr>
<tr>
<td>Retained earnings (W4)</td>
<td>325,400</td>
</tr>
<tr>
<td>Non-controlling interest (W4)</td>
<td>143,800</td>
</tr>
<tr>
<td>Payables</td>
<td>90,000</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>639,200</td>
</tr>
</tbody>
</table>
Workings

1 Group structure

```
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>P</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1.7.20X5 80%</td>
</tr>
<tr>
<td>S</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1.7.20X4 60%</td>
</tr>
<tr>
<td>SS</td>
<td></td>
</tr>
</tbody>
</table>
```

P owns an effective interest of 48% in SS. NCI in SS is 52%.

2 Goodwill

The working should be set out as:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>120,000</td>
<td>(80% × 110,000)</td>
</tr>
<tr>
<td>Non-controlling interests</td>
<td>(20% × 28,000)</td>
<td>(52% × 160,000)</td>
</tr>
</tbody>
</table>
| Fair value of identifiable NA acquired:  
  Share capital | 100,000 | 100,000 |
  Retained earnings | 40,000 | 60,000 |
  (140,000) | (160,000) | 8,000 |
|                 | 19,200 |

Note: Retained earnings of SS are as at 1 July 20X5 when P acquired control of S.

3 Post-acquisition retained earnings

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>S Co (170,000 – 40,000)</td>
<td>130,000</td>
</tr>
<tr>
<td>SS Co (115,000 – 60,000)</td>
<td>55,000</td>
</tr>
</tbody>
</table>

The cost of investment in SS is again deducted as the NCI is being calculated on the net assets that have been consolidated (see note above).

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>NCI's share of post-acquisition retained earnings (S Co: 130,000 × 20%, SS Co: 55,000 × 52%)</td>
<td>26,000</td>
<td>28,600</td>
</tr>
<tr>
<td>Less NCI in investment in SS (110,000 × 20%)</td>
<td>(22,000)</td>
<td>–</td>
</tr>
<tr>
<td></td>
<td>4,000</td>
<td>28,600</td>
</tr>
</tbody>
</table>

4 Consolidation schedule

<table>
<thead>
<tr>
<th></th>
<th>P</th>
<th>$'000</th>
<th>S</th>
<th>$'000</th>
<th>SS</th>
<th>$'000</th>
<th>W2(i)</th>
<th>$'000</th>
<th>W2(ii)</th>
<th>$'000</th>
<th>W3 (i)</th>
<th>$'000</th>
<th>W3 (ii)</th>
<th>$'000</th>
<th>Consolidated</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>NC assets</td>
<td>105</td>
<td>125</td>
<td>180</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>410</td>
</tr>
<tr>
<td>Investment</td>
<td>120</td>
<td>110</td>
<td>–</td>
<td>(120)</td>
<td>(88)</td>
<td>(22)</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Goodwill</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>8</td>
<td>11.2</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>19.2</td>
</tr>
<tr>
<td>C assets</td>
<td>80</td>
<td>70</td>
<td>60</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>210</td>
</tr>
<tr>
<td>S capital</td>
<td>80</td>
<td>100</td>
<td>100</td>
<td>(100)</td>
<td>(100)</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>80</td>
</tr>
<tr>
<td>R earnings</td>
<td>195</td>
<td>170</td>
<td>115</td>
<td>(40)</td>
<td>(60)</td>
<td>(26)</td>
<td>(28.6)</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>325.4</td>
</tr>
<tr>
<td>NCI</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>28</td>
<td>83.2</td>
<td>4</td>
<td>28.6</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>143.8</td>
</tr>
<tr>
<td>Payables</td>
<td>30</td>
<td>35</td>
<td>25</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>90</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>639.2</td>
</tr>
</tbody>
</table>

Retained earnings of SS are as at 1 July 20X5 when P acquired control of S.
### Step by Step calculation in a schematic form

<table>
<thead>
<tr>
<th>Timeline</th>
<th>S takes control of SS</th>
<th>P takes control of S</th>
<th>Reporting Date</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>S + SS's fair value of identifiable net asset</strong></td>
<td>$140 (S's equity) + $160 (SS's equity) = $190</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>(Note: There is a need to deduct the cost of investment in SS from S's equity as cost of investment would be represented in SS's equity)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>NCI's share of S + SS</strong></td>
<td>($140k × 20%) + ($160k × 52%) – ($110k × 20%) = $89.2k</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
<td>$120 (Cost of investment by P) + $89.20 – $190 = $19.20</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Changes in reserves in S</strong></td>
<td>$170 (at reporting date) – $40 (at acquisition date) = $130</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>P's share</strong></td>
<td>$130 80% = $104 (P-1)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>NCI's share</strong></td>
<td>$130 20% = $26.4 (NCI-2)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Changes in reserves in SS</strong></td>
<td>$115 (at reporting date) – $60 (at acquisition date) = $55</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>P's share</strong></td>
<td>$55 48% = $26.4 (P-2)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>NCI's share</strong></td>
<td>$55 52% = $28.6 (NCI-3)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### 2.4 Subsidiary acquired first

As discussed in section 1.3, in the situation where the parent company acquires the subsidiary before the sub-subsidiary is acquired, the later acquisition can be viewed either as:

- An acquisition of the parent company; or
- An acquisition of the group.

The calculation of the non-controlling interest will differ depending on which approach is taken. The first example below considers the acquisition of the sub-subsidiary to be an acquisition **by the group**.

**Example**

**Subsidiary acquired first 1**

Using the figures from the previous example in Section 2.2, assume that:

(a) P Co purchased its holding in S Co on 1 July 20X4 when the reserves of S Co were $40,000
(b) S Co purchased its holding in SS Co on 1 July 20X5 when the reserves of SS Co were $50,000

It is the group's policy to measure the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.
Solution

There are **two acquisitions** from the point of view of the P group. In 20X4, P buys 80% of S. Then in 20X5 the group buys 60% of SS. The solution presented here uses the indirect interest method.

1. **Group structure**

   ![Group structure diagram]

   - The group interest in SS is 60%
   - The NCI in SS is 40%

2. **Goodwill**

   Compare the costs of investments with the group interests acquired (80% of S Co and 60% of SS Co).

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>P in S</strong></td>
<td>120,000</td>
<td>110,000</td>
<td></td>
</tr>
<tr>
<td><strong>S in SS</strong></td>
<td>110,000</td>
<td>120,000</td>
<td></td>
</tr>
</tbody>
</table>

   **Consideration transferred**

   **Non-controlling interests**

   - (20% × 140,000) = 28,000
   - (40% × 150,000) = 60,000

   **Fair value of identifiable NA acquired:**

   - Share capital: 100,000
   - Retained earnings: 40,000

   **Journals (in $)**

   (i) Goodwill in S

   | DEBIT Share capital | 100,000 |
   | DEBIT Retained earnings | 40,000 |
   | DEBIT Goodwill | 8,000 |
   | CREDIT NCI | 28,000 |
   | CREDIT Investment in S | 120,000 |

   to recognise goodwill on the acquisition of S and eliminate the investment against pre-acquisition share capital and reserves

   (ii) Goodwill in SS

   | DEBIT Share capital | 100,000 |
   | DEBIT Retained earnings | 50,000 |
   | DEBIT Goodwill | 20,000 |
   | CREDIT NCI | 60,000 |
   | CREDIT Investment in SS | 110,000 |

   to recognise goodwill on the acquisition of SS and eliminate the investment against pre-acquisition share capital and reserves
3  

Retained earnings and NCI

<table>
<thead>
<tr>
<th></th>
<th>S Co</th>
<th>SS Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>170,000</td>
<td>115,000</td>
</tr>
<tr>
<td>Per question</td>
<td>(40,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Pre-acquisition</td>
<td>130,000</td>
<td>65,000</td>
</tr>
<tr>
<td>Post-acquisition</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Allocate post-acquisition profits to the non-controlling interests in the usual way, using a 20% NCI in S Co's post-acquisition retained earnings and a 40% non-controlling interests in SS Co's post-acquisition retained earnings.

\[
\text{NCI's share of post-acquisition retained earnings} = \frac{130,000 \times 20%}{65,000 \times 40%} = 26,000 \text{ } 26,000
\]

Journals (in $)

(i) Allocation of profits to S's NCI

\[
\text{DEBIT Group retained earnings 26,000 CREDIT NCI 26,000}
\]
to recognise the NCI share of S's post-acquisition profits

(ii) Allocation of profits to SS's NCI

\[
\text{DEBIT Group retained earnings 26,000 CREDIT NCI 26,000}
\]
to recognise the NCI share of SS's post-acquisition profits

4  

Consolidation schedule

<table>
<thead>
<tr>
<th></th>
<th>P</th>
<th>S $'000</th>
<th>SS $'000</th>
<th>W2(i) $'000</th>
<th>W2(ii) $'000</th>
<th>W3 (i) $'000</th>
<th>W3 (ii) $'000</th>
<th>Consolidated $'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tangible NC assets</td>
<td>105</td>
<td>125</td>
<td>180</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>410</td>
</tr>
<tr>
<td>Investment</td>
<td>120</td>
<td>110</td>
<td>-</td>
<td>(120)</td>
<td>(110)</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Goodwill</td>
<td>-</td>
<td>-</td>
<td>8</td>
<td>20</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>28</td>
</tr>
<tr>
<td>C assets</td>
<td>80</td>
<td>70</td>
<td>60</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>210</td>
</tr>
<tr>
<td>S capital</td>
<td>80</td>
<td>100</td>
<td>100</td>
<td>(100)</td>
<td>(100)</td>
<td>-</td>
<td>-</td>
<td>80</td>
</tr>
<tr>
<td>R earnings</td>
<td>195</td>
<td>170</td>
<td>115</td>
<td>(40)</td>
<td>(50)</td>
<td>(26)</td>
<td>(26)</td>
<td>338</td>
</tr>
<tr>
<td>NCI</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>28</td>
<td>60</td>
<td>26</td>
<td>26</td>
<td>140</td>
</tr>
<tr>
<td>Payables</td>
<td>30</td>
<td>35</td>
<td>25</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>90</td>
</tr>
</tbody>
</table>

P CO

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 30 JUNE 20X7

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
</tr>
<tr>
<td>Tangible assets</td>
<td>410,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>28,000</td>
</tr>
<tr>
<td>Current assets</td>
<td>210,000</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital (80,000 shares fully paid)</td>
<td>80,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>338,000</td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>418,000</td>
</tr>
<tr>
<td>Payables</td>
<td>558,000</td>
</tr>
<tr>
<td></td>
<td>90,000</td>
</tr>
<tr>
<td></td>
<td>648,000</td>
</tr>
</tbody>
</table>
Step by step calculation in a schematic form

1.7.20X4

S's fair value of identifiable net asset
= $140 (S's equity)
NCI's share of S
= 20% x $140 (S's equity)
= $28 (NCI-1)
Goodwill =
= $120 (Cost of investment by P) + $26 - $140
= $8

Changes in reserves in S
= $170 (at reporting date) - $40 (at acquisition date)
= $130
P's share
= $130 x 80% = $104 (P-1)
NCI's share
= $130 x 20% = $26 (NCI-2)

30.6.20X7

P's reserves at reporting date
= $195 (P's own reserves) + $104 (P-1) + $31.2 (P-2)
= $330.2
NCI as at reporting date
= $28 (NCI-1) + $26 (NCI-2) + $60 (NCI-3) + $33.80
= $147.80

1.7.20X5

S takes control of SS

Changes in reserves in SS
= $115 (at reporting date) - $50 (at acquisition date)
= $65
P's share
= $65 x 60% = $39 (P-2)
NCI's share
= $65 x 40% = $26 (NCI-4)

SS's fair value of identifiable net asset
= $150 (SS's equity)
NCI's share of SS
= 40% x $150 (SS's equity)
= $60 (NCI-3)
Goodwill
= ($110,000 x 80%) + ($150,000 x 52%) - $150
= $16,000

Example

Subsidiary acquired first 2

Rework the consolidation schedule for the example above, this time considering the acquisition of SS as an acquisition of P, so using group and NCI effective shareholdings in SS in your calculations.

Solution

1. Group structure
As we are viewing the acquisition of SS as an acquisition by P, it is the case that

- P's interest in SS is 80% × 60% = 48%
- The NCI interest in S is therefore 52%, made up of:
  - The interest of the NCI in S 20% × 60% = 12%
  - The interest of the NCI in SS = 40%

2 Goodwill

Compare the costs of investments with the group interests acquired (80% of S Co and 48% of SS Co).

<table>
<thead>
<tr>
<th></th>
<th>P in S</th>
<th>$</th>
<th>S in SS</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>120,000</td>
<td>(80% × $110,000)</td>
<td>88,000</td>
<td></td>
</tr>
<tr>
<td>Non-controlling interests</td>
<td>(20% × 140,000)</td>
<td>28,000</td>
<td>(52% × 150,000)</td>
<td>78,000</td>
</tr>
<tr>
<td>Fair value of identifiable NA acquired:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>100,000</td>
<td>100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>40,000</td>
<td>50,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(140,000)</td>
<td>(150,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>8,000</td>
<td>16,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>24,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Journals (in $)**

(i) Goodwill in S

<table>
<thead>
<tr>
<th></th>
<th>DEBIT</th>
<th>Share capital</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DEBIT</td>
<td>Retained earnings</td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>DEBIT</td>
<td>Goodwill</td>
<td>8,000</td>
</tr>
<tr>
<td></td>
<td>CREDIT</td>
<td>NCI</td>
<td>28,000</td>
</tr>
<tr>
<td></td>
<td>CREDIT</td>
<td>Investment in S</td>
<td>120,000</td>
</tr>
</tbody>
</table>

(ii) Goodwill in SS

<table>
<thead>
<tr>
<th></th>
<th>DEBIT</th>
<th>Share capital</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DEBIT</td>
<td>Retained earnings</td>
<td>50,000</td>
</tr>
<tr>
<td></td>
<td>DEBIT</td>
<td>Goodwill</td>
<td>16,000</td>
</tr>
<tr>
<td></td>
<td>CREDIT</td>
<td>NCI</td>
<td>78,000</td>
</tr>
<tr>
<td></td>
<td>CREDIT</td>
<td>Investment in SS</td>
<td>88,000</td>
</tr>
</tbody>
</table>

3 Retained earnings and NCI

<table>
<thead>
<tr>
<th></th>
<th>S Co</th>
<th>$</th>
<th>SS Co</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per question</td>
<td>170,000</td>
<td>115,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pre-acquisition</td>
<td>(40,000)</td>
<td>(50,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Post-acquisition</td>
<td>130,000</td>
<td>65,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Allocate post-acquisition profits to the non-controlling interests in the usual way, using a 20% NCI in S Co's post-acquisition retained earnings and a 52% non-controlling interest in SS Co's post-acquisition retained earnings.
27: Complex groups | PART G CONSOLIDATED FINANCIAL STATEMENTS

NCI

<table>
<thead>
<tr>
<th>S</th>
<th>SS</th>
</tr>
</thead>
<tbody>
<tr>
<td>$130,000 × 20%)/($65,000 × 52%)</td>
<td>26,000</td>
</tr>
</tbody>
</table>

Less NCI in S’s investment in SS (20% × $110,000)

(22,000)

4,000

Journals (in $)

(i) Allocation of profits to S’s NCI

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group retained earnings</td>
<td>NCI</td>
</tr>
<tr>
<td>Investment</td>
<td>22,000</td>
</tr>
</tbody>
</table>

to recognise the NCI share of S’s post-acquisition profits

(ii) Allocation of profits to SS’s NCI

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group retained earnings</td>
<td>NCI</td>
</tr>
</tbody>
</table>
| to recognise the NCI share of SS’s post-acquisition profits

4 Consolidation schedule

<table>
<thead>
<tr>
<th>P Co</th>
<th>S Co</th>
<th>SS Co</th>
<th>W2(i)</th>
<th>W2(ii)</th>
<th>W3 (i)</th>
<th>W3 (ii)</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tangible NC assets</td>
<td>105</td>
<td>125</td>
<td>180</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>410</td>
</tr>
<tr>
<td>Investment</td>
<td>120</td>
<td>110</td>
<td>–</td>
<td>(120)</td>
<td>(88)</td>
<td>(22)</td>
<td>–</td>
</tr>
<tr>
<td>Goodwill</td>
<td>–</td>
<td>–</td>
<td>8</td>
<td>16</td>
<td>–</td>
<td>–</td>
<td>24</td>
</tr>
<tr>
<td>C assets</td>
<td>80</td>
<td>70</td>
<td>60</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>210</td>
</tr>
<tr>
<td>S capital</td>
<td>80</td>
<td>100</td>
<td>100</td>
<td>(100)</td>
<td>(100)</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>R earnings</td>
<td>195</td>
<td>170</td>
<td>115</td>
<td>(40)</td>
<td>(50)</td>
<td>(26)</td>
<td>(33.8)</td>
</tr>
<tr>
<td>NCI</td>
<td>–</td>
<td>–</td>
<td>28</td>
<td>78</td>
<td>4</td>
<td>33.8</td>
<td>143.8</td>
</tr>
<tr>
<td>Payables</td>
<td>30</td>
<td>35</td>
<td>25</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>90</td>
</tr>
</tbody>
</table>

2.5 Non-controlling interest at fair value

Where the NCI is measured at fair value, the same principles as seen throughout section 2 apply.

Example

Subsidiary acquired first: non-controlling interest at fair value

The draft statements of financial position of P Co, S Co and SS Co on 30 June 20X7 were as follows.

<table>
<thead>
<tr>
<th>P Co</th>
<th>S Co</th>
<th>SS Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Tangible assets</td>
<td>105,000</td>
<td>125,000</td>
</tr>
<tr>
<td>Investments, at cost</td>
<td>120,000</td>
<td>–</td>
</tr>
<tr>
<td>shares in S Co</td>
<td>–</td>
<td>110,000</td>
</tr>
<tr>
<td>shares in SS Co</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Current assets</td>
<td>80,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Equity and liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>80,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>195,000</td>
<td>170,000</td>
</tr>
<tr>
<td>Payables</td>
<td>30,000</td>
<td>35,000</td>
</tr>
<tr>
<td></td>
<td>305,000</td>
<td>305,000</td>
</tr>
</tbody>
</table>
P Co acquired its shares in S Co on 1 July 20X4 when the reserves of S Co stood at $40,000; and S Co acquired its shares in SS Co on 1 July 20X5 when the reserves of SS Co stood at $50,000.

It is the group's policy to measure the non-controlling interest at fair value at the date of acquisition. The fair value of the non-controlling interest in S on 1 July 20X4 was $29,000. The fair value of the non-controlling interest on 1 July 20X5 was $80,000.

Prepare the draft consolidated statement of financial position of P Group at 30 June 20X7.

Notes:
1. Assume no impairment of goodwill
2. Assume that the acquisition of SS is treated as the acquisition of a 60% holding in SS by the group rather than the acquisition of a 48% holding by P.

Solution

The group's policy on measurement of the non-controlling interest at acquisition does not change the steps we follow in the consolidation.

P CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 30 JUNE 20X7

<table>
<thead>
<tr>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>Non-current assets</td>
</tr>
<tr>
<td>Tangible assets</td>
</tr>
<tr>
<td>Goodwill (W2)</td>
</tr>
<tr>
<td>Current assets</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
</tr>
<tr>
<td>Ordinary share capital (80,000 shares fully paid)</td>
</tr>
<tr>
<td>Retained earnings (W4)</td>
</tr>
<tr>
<td><strong>Non-controlling interest (W4)</strong></td>
</tr>
<tr>
<td><strong>Payables</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

1. **Group structure**

```
P
   1.7.20X4  80%

S
   1.7.20X5  60%

SS
```

The question states that the acquisition of SS is viewed as an acquisition of the sub-subsidiary by the group, and therefore the ownership percentages in SS are:

- Group 60%
- NCI 40%
2  

**Goodwill**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consideration transferred</strong></td>
<td>120,000</td>
<td>110,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Non-controlling interests (at FV)</strong></td>
<td>29,000</td>
<td>80,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Fair value of identifiable net assets acquired</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>100,000</td>
<td>100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>40,000</td>
<td>50,000</td>
<td>(140,000)</td>
<td>(150,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>9,000</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$49,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Journals (in $)**

(i) **Goodwill in S**

- **DEBIT** Share capital 100,000
- **DEBIT** Retained earnings 40,000
- **DEBIT** Goodwill 9,000
- **CREDIT** NCI 29,000
- **CREDIT** Investment in S 120,000

To recognise goodwill on the acquisition of S and eliminate the investment against pre-acquisition share capital and reserves.

(ii) **Goodwill in SS**

- **DEBIT** Share capital 100,000
- **DEBIT** Retained earnings 50,000
- **DEBIT** Goodwill 40,000
- **CREDIT** NCI 80,000
- **CREDIT** Investment in SS 110,000

To recognise goodwill on the acquisition of SS and eliminate the investment against pre-acquisition share capital and reserves.

3  

**Retained earnings**

<table>
<thead>
<tr>
<th></th>
<th>S Co</th>
<th>SS Co</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Per question</strong></td>
<td>170,000</td>
<td>115,000</td>
</tr>
<tr>
<td><strong>Pre-acquisition</strong></td>
<td>(40,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td><strong>Post-acquisition</strong></td>
<td>130,000</td>
<td>65,000</td>
</tr>
</tbody>
</table>

Post-acquisition profits are allocated to the NCI as before.

**NCI's share of post-acquisition retained earnings**

\[ \frac{(130,000 \times 20\%)}{(65,000 \times 40\%)} \]  

26,000  

26,000

**Journals (in $)**

(i) **Allocation of profits to S's NCI**

- **DEBIT** Group retained earnings 26,000
- **CREDIT** NCI 26,000

To recognise the NCI share of S's post-acquisition profits.

(ii) **Allocation of profits to SS's NCI**

- **DEBIT** Group retained earnings 26,000
- **CREDIT** NCI 26,000

To recognise the NCI share of SS's post-acquisition profits.
### Consolidation schedule

<table>
<thead>
<tr>
<th></th>
<th>P $000</th>
<th>S $000</th>
<th>SS $000</th>
<th>W2(i) $000</th>
<th>W2(ii) $000</th>
<th>W3 (i) $000</th>
<th>W3 (ii) $000</th>
<th>Consolidated $000</th>
</tr>
</thead>
<tbody>
<tr>
<td>NC assets</td>
<td>105</td>
<td>125</td>
<td>180</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Investment</td>
<td>120</td>
<td>110</td>
<td>–</td>
<td>(120)</td>
<td>(110)</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Goodwill</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>9</td>
<td>40</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>C assets</td>
<td>80</td>
<td>70</td>
<td>60</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>S capital</td>
<td>80</td>
<td>100</td>
<td>100</td>
<td>(100)</td>
<td>(100)</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>R earnings</td>
<td>195</td>
<td>170</td>
<td>115</td>
<td>(40)</td>
<td>(50)</td>
<td>(26)</td>
<td>(26)</td>
<td>338</td>
</tr>
<tr>
<td>NCI</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>29</td>
<td>80</td>
<td>26</td>
<td>26</td>
<td>161</td>
</tr>
<tr>
<td>Payables</td>
<td>30</td>
<td>35</td>
<td>25</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>90</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>410</strong></td>
<td><strong>669</strong></td>
<td><strong>49</strong></td>
<td><strong>49</strong></td>
<td><strong>210</strong></td>
<td><strong>161</strong></td>
<td><strong>161</strong></td>
<td><strong>669</strong></td>
</tr>
</tbody>
</table>

### Step by Step calculation in a schematic form

#### Timeline

**1.7.20X4**
- **P** takes control of **S**

**1.7.20X5**
- **S** takes control of **SS**

**30.6.20X7**
- **Reporting Date**

#### Changes in reserves in **S**
- $170 (at reporting date) – $40 (at acquisition date)
- $130
- **P**’s share
- $130 x 80% = $104 (P-1)
- **NCI**’s share
- $130 x 20% = $26 (NCI-2)

#### Changes in reserves in **SS**
- $115 (at reporting date) – $50 (at acquisition date)
- $65
- **P**’s share
- $65 x 60% = $39 (P-2)
- **NCI**’s share
- $65 x 40% = $26 (NCI-4)

### Question 27.2

**NCI at fair value**

Rework the example above using the same numbers, however this time treating the acquisition of the sub-subsidiary as an acquisition by the parent company of a 48% effective holding in the sub-subsidiary.
Question 27.3

The statements of financial position of Antelope Co, Yak Co and Zebra Co at 31 March 20X4 are summarised as follows.

<table>
<thead>
<tr>
<th></th>
<th>Antelope Co</th>
<th>Yak Co</th>
<th>Zebra Co</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Freehold property</td>
<td>100,000</td>
<td>100,000</td>
<td>–</td>
</tr>
<tr>
<td>Plant and machinery</td>
<td>210,000</td>
<td>80,000</td>
<td>3,000</td>
</tr>
<tr>
<td></td>
<td>310,000</td>
<td>180,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Investments in subsidiaries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares, at cost</td>
<td>110,000</td>
<td>6,200</td>
<td></td>
</tr>
<tr>
<td>Current accounts</td>
<td>10,000</td>
<td>16,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>120,000</td>
<td>22,200</td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>170,000</td>
<td>20,500</td>
<td>15,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>140,000</td>
<td>50,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Cash at bank</td>
<td>60,000</td>
<td>16,500</td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>370,000</td>
<td>87,000</td>
<td>20,000</td>
</tr>
<tr>
<td></td>
<td>800,000</td>
<td>289,200</td>
<td>23,000</td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>200,000</td>
<td>100,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>379,600</td>
<td>129,200</td>
<td>(1,000)</td>
</tr>
<tr>
<td></td>
<td>579,600</td>
<td>229,200</td>
<td>9,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade payables</td>
<td>157,000</td>
<td>43,000</td>
<td>1,400</td>
</tr>
<tr>
<td>Due to Antelope Co</td>
<td>–</td>
<td>10,000</td>
<td>–</td>
</tr>
<tr>
<td>Due to Yak Co</td>
<td>3,400</td>
<td>–</td>
<td>12,600</td>
</tr>
<tr>
<td>Taxation</td>
<td>60,000</td>
<td>7,000</td>
<td>–</td>
</tr>
<tr>
<td></td>
<td>220,400</td>
<td>60,000</td>
<td>14,000</td>
</tr>
<tr>
<td></td>
<td>800,000</td>
<td>289,200</td>
<td>23,000</td>
</tr>
</tbody>
</table>

Antelope Co acquired 75% of the shares of Yak Co in 20X1 when the credit balance on the retained earnings of that company was $40,000. No dividends have been paid since that date. Yak Co acquired 80% of the shares in Zebra Co in 20X3 when there was a debit balance on the retained earnings of that company of $3,000. Subsequently $500 was received by Zebra Co and credited to its retained earnings, representing the recovery of an irrecoverable debt written off before the acquisition of Zebra’s shares by Yak Co. During the year to 31 March 20X4 Yak Co purchased inventory from Antelope Co for $20,000 which included a profit mark-up of $4,000 for Antelope Co. At 31 March 20X4 one half of this amount was still held in the inventories of Yak Co.

It is the group’s policy to measure the non-controlling interest at its proportionate share of the fair value of the subsidiary’s identifiable net assets.

Prepare the draft consolidated statement of financial position of Antelope Co at 31 March 20X4. (Assume no impairment of goodwill and assume that the acquisition of Zebra Co is treated as an acquisition of a subsidiary by the group.)
2.6 Section summary

You should follow this **step by step approach** in all questions. This applies to section 3 below as well.

**STEP 1**
Sketch the group **structure** and check it to the question.

**STEP 2**
**Add details** to the sketch of dates of acquisition, holdings acquired and NCI (percentage and nominal values) and cost.

**STEP 3**
Use the notes in the question to make adjustments such as eliminating intra-group balances and unrealised profits.

**STEP 4**
**Goodwill working.** Compare consideration transferred with group interests acquired.

**STEP 5**
**Calculate post-acquisition reserves in the subsidiaries.**

**STEP 6**
**Work** methodically down the statement of financial position, transferring figures to your schedule.

**STEP 7**
Draw up a **consolidation schedule.**

**STEP 8**
Allocate post-acquisition reserves to the **non-controlling interests working.**

**STEP 9**
Prepare the **consolidated statement of financial position** (and statement of profit or loss and other comprehensive income if required).
SECTION SUMMARY

When dealing with sub-subsidiaries, the effective interest owned by the group and by the non-controlling interest must be calculated. These may impact the goodwill and NCI calculations. The date of acquisition must be considered when dealing with sub-subsidiaries.

3 Direct holdings in sub-subsidiaries

SECTION INTRODUCTION

'D shaped' groups arise where both a parent and its subsidiary have an investment in a further subsidiary.

Consider the following structure, sometimes called a 'D-shaped' group.

\[
\begin{array}{c}
P \\
\text{80%} \\
S \\
\text{20% (NCI direct)} \\
\text{75%} \\
SS \\
\text{15% (NCI direct)}
\end{array}
\]

In the structure above, there is:

(a) A direct non-controlling share in S of \( \frac{20}{100} \) 
(b) A direct non-controlling share in SS of \( \frac{15}{100} \) 
(c) An indirect non-controlling share in SS of \( 20\% \times 75\% = \frac{15}{100} \) 

The effective interest in SS is:

\[
\begin{align*}
\text{Group}\ 80\% \times 75\% &= 60\% \text{ interest} \\
\text{Direct holding} &= 10\% \\
\therefore \text{NCI} &= 30\% \\
70\% &= 100\%
\end{align*}
\]

Having ascertained the structure and non-controlling interests, proceed as for a typical sub-subsidiary situation. Because of the direct holding by P the indirect interest method is much more likely to be appropriate.
### Question 27.4  

**‘D’ shaped group**

The draft statements of financial position of Hwee Ltd, Ming Ltd and Panda Ltd as at 31 May 20X5 are as follows.

<table>
<thead>
<tr>
<th></th>
<th>Hwee Ltd</th>
<th>Ming Ltd</th>
<th>Panda Ltd</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tangible assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments in subsidiaries (cost)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares in Ming Ltd</td>
<td>90,000</td>
<td>–</td>
<td></td>
</tr>
<tr>
<td>Shares in Panda Ltd</td>
<td>25,000</td>
<td>42,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>115,000</td>
<td>42,000</td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>205,000</td>
<td>102,000</td>
<td>60,000</td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary shares</td>
<td>100,000</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Revaluation surplus</td>
<td>50,000</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>45,000</td>
<td>32,000</td>
<td>25,000</td>
</tr>
<tr>
<td></td>
<td>195,000</td>
<td>102,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Non-current liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12% loan</td>
<td>–</td>
<td>10,000</td>
<td>–</td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payables</td>
<td>50,000</td>
<td>40,000</td>
<td>25,000</td>
</tr>
<tr>
<td></td>
<td>245,000</td>
<td>152,000</td>
<td>100,000</td>
</tr>
</tbody>
</table>

(a) Hwee acquired 60% of the shares in Ming on 1 January 20X3 when the balance on that company's retained earnings was $8,000 (credit) and there was no revaluation surplus.

(b) Hwee acquired 20% of the shares of Panda and Ming acquired 60% of the shares of Panda on 1 January 20X4 when that company's retained earnings stood at $15,000.

(c) There has been no payment of dividends by either Ming or Panda since they became subsidiaries.

(d) There has been no impairment of goodwill.

(e) It is the group's policy to measure the non-controlling interest at acquisition at its proportionate share of the fair value of the subsidiary's identifiable net assets.

The indirect method is used to measure Hwee's interest in Panda.

**Required**

Prepare the draft consolidated statement of financial position of Hwee Ltd as at 31 May 20X5.

Note that the shares in the sub-subsidiary are acquired by the parent and the subsidiary on the same date in the example above. Where shares are not acquired on the same date you should consider whether the acquisition of the sub-subsidiary is a step acquisition (see Chapter 28).

### SECTION SUMMARY

**‘D shaped’ groups** are consolidated in the same way as a typical sub-subsidiary situation. Identifying the correct group structure and calculating the non-controlling interest are important.
Chapter Roundup

Complex group

Sub-subsidiaries
- Subsidiary acquired first

D-shaped groups
- Sub-subsidiary acquired first
Quick Quiz

1. B Co acquired 60% of the equity of C Co which already owned 75% of the equity of D Co. What is the total non-controlling interest percentage in D Co?

2. What is the basic consolidation approach for including sub-subsidiaries in a consolidated statement of financial position?

3. P Co owns 25% of R Co's equity and 75% of Q Co's equity. Q Co owns 40% of R Co's equity. What is the total non-controlling interest percentage ownership in R Co?
### Answers to Quick Quiz

1. B
   - 60%

2. C
   - 75%

3. D
   - Non-controlling interest = 25% + (40% of 75%) = 55%

### Answers to Questions

#### 27.1 Effective interest

Top owns 60% of 75% of Bottom Co = 45%.

#### 27.2 NCI at fair value

<table>
<thead>
<tr>
<th>P CO</th>
</tr>
</thead>
<tbody>
<tr>
<td>CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 30 JUNE 20X7</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>Non-current assets</td>
</tr>
<tr>
<td>Tangible assets</td>
</tr>
<tr>
<td>Goodwill (W2)</td>
</tr>
<tr>
<td>Current assets</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
<tr>
<td><strong>Equity</strong></td>
</tr>
<tr>
<td>Ordinary share capital (80,000 shares fully paid)</td>
</tr>
<tr>
<td>Retained earnings (W4)</td>
</tr>
<tr>
<td>Non-controlling interest (W4)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
<tr>
<td>Payables</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>
1. **Group structure**

\[
\begin{array}{c}
P \\
S \\
SS
\end{array}
\]

1.7.20X4 80%
1.7.20X5 60%

The question states that the acquisition of SS is viewed as an acquisition of the sub-subsidiary by the parent, and therefore the ownership percentages in SS are:

- Group 48%
- NCI 52%

2. **Goodwill**

<table>
<thead>
<tr>
<th></th>
<th>( P ) in ( S )</th>
<th></th>
<th>( S ) in SS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>$120,000</td>
<td>$88,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-controlling interests (at FV)</td>
<td>$29,000</td>
<td>$80,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fair value of identifiable net assets acquired</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>$100,000</td>
<td>$100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>$40,000</td>
<td>$50,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$(140,000)</td>
<td>$(150,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$9,000</td>
<td>$18,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$27,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Journals (in $)**

(i) Goodwill in \( S \)
- DEBIT Share capital $100,000
- DEBIT Retained earnings $40,000
- DEBIT Goodwill $9,000
- CREDIT NCI $29,000
- CREDIT Investment in \( S \) $120,000

To recognise goodwill on the acquisition of \( S \) and eliminate the investment against pre-acquisition share capital and reserves.

(ii) Goodwill in \( SS \)
- DEBIT Share capital $100,000
- DEBIT Retained earnings $50,000
- DEBIT Goodwill $18,000
- CREDIT NCI $80,000
- CREDIT Investment in \( SS \) $88,000

To recognise goodwill on the acquisition of \( SS \) and eliminate the investment against pre-acquisition share capital and reserves.
3  

Retained earnings

<table>
<thead>
<tr>
<th></th>
<th>S Co $</th>
<th>SS Co $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per question</td>
<td>170,000</td>
<td>115,000</td>
</tr>
<tr>
<td>Pre-acquisition</td>
<td>(40,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Post-acquisition</td>
<td>130,000</td>
<td>65,000</td>
</tr>
</tbody>
</table>

Post-acquisition profits are allocated to the NCI as before.

<table>
<thead>
<tr>
<th></th>
<th>S $</th>
<th>SS $</th>
</tr>
</thead>
<tbody>
<tr>
<td>NCI's share of post-acquisition retained earnings ($130,000 × 20%)/($65,000 × 52%)</td>
<td>26,000</td>
<td>33,800</td>
</tr>
<tr>
<td>Less NCI in S's investment in SS (20% × $110,000)</td>
<td>(22,000)</td>
<td>4,000</td>
</tr>
</tbody>
</table>

Journals (in $)

(i) Allocation of profits to S's NCI

DEBIT  
Group retained earnings  26,000

CREDIT  
NCI  4,000

CREDIT  
Investment  22,000

To recognise the NCI share of S's post-acquisition profits

(ii) Allocation of profits to SS's NCI

DEBIT  
Group retained earnings  33,800

CREDIT  
NCI  33,800

To recognise the NCI share of SS's post-acquisition profits

4  

Consolidation schedule

<table>
<thead>
<tr>
<th>P</th>
<th>S</th>
<th>SS</th>
<th>W2(i)</th>
<th>W2(ii)</th>
<th>W3(i)</th>
<th>W3(ii)</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>NC assets</td>
<td>105</td>
<td>125</td>
<td>180</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>410</td>
</tr>
<tr>
<td>Investment</td>
<td>120</td>
<td>110</td>
<td>–</td>
<td>(120)</td>
<td>(88)</td>
<td>(22)</td>
<td>–</td>
</tr>
<tr>
<td>Goodwill</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>9</td>
<td>18</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>C assets</td>
<td>80</td>
<td>70</td>
<td>60</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>S capital</td>
<td>80</td>
<td>100</td>
<td>100</td>
<td>(100)</td>
<td>(100)</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>R earnings</td>
<td>195</td>
<td>170</td>
<td>115</td>
<td>(40)</td>
<td>(50)</td>
<td>(26)</td>
<td>(33.8)</td>
</tr>
<tr>
<td>NCI</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>29</td>
<td>80</td>
<td>4</td>
<td>33.8</td>
</tr>
<tr>
<td>Payables</td>
<td>30</td>
<td>35</td>
<td>25</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>

Total: 647

27.3  

Vertical group

Sub-subsidiary

```
20X1
Y
Z

20X3
```

75%

80%
Workings

1  Goodwill

<table>
<thead>
<tr>
<th>A in Y</th>
<th>$</th>
<th>Y in Z</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>$110,000</td>
<td>$6,200</td>
<td></td>
</tr>
<tr>
<td>Non-controlling interests</td>
<td>(25% × 140,000)</td>
<td>(20% × 7,500)</td>
<td></td>
</tr>
<tr>
<td>Fair value of identifiable NA acquired:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>100,000</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings: ($3,000) + $500</td>
<td>40,000</td>
<td>(140,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(2,500)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(7,500)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>200</td>
<td></td>
</tr>
</tbody>
</table>

Journals (in $)

(i) Goodwill in Y

DEBIT  Share capital  100,000
DEBIT  Retained earnings  40,000
DEBIT  Goodwill  5,000
CREDIT  NCI  35,000
CREDIT  Investment in Y  110,000

to recognise goodwill on the acquisition of Yak and eliminate the investment against pre-acquisition share capital and reserves

(ii) Goodwill in Z

DEBIT  Share capital  10,000
DEBIT  Goodwill  200
CREDIT  Retained earnings  2,500
CREDIT  NCI  1,500
CREDIT  Investment in Z  6,200

to recognise goodwill on the acquisition of Zebra and eliminate the investment against pre-acquisition share capital and reserves

2  Retained earnings

<table>
<thead>
<tr>
<th></th>
<th>Yak</th>
<th>Zebra</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td></td>
<td>$</td>
</tr>
<tr>
<td>Per question</td>
<td>129,200</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Adjustment irrecoverable recovery</td>
<td>(500)</td>
<td></td>
</tr>
<tr>
<td>Pre-acquisition profit/losses</td>
<td>(40,000)</td>
<td>3,000</td>
</tr>
<tr>
<td>Post-acquisition profits</td>
<td>89,200</td>
<td>1,500</td>
</tr>
</tbody>
</table>

Allocate to NCI:

<table>
<thead>
<tr>
<th></th>
<th>Yak</th>
<th>Zebra</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td></td>
<td>$</td>
</tr>
<tr>
<td>NCI's share of post-acquisition retained earnings ($89,200 × 25%)/($1,500 × 20%)</td>
<td>22,300</td>
<td>300</td>
</tr>
</tbody>
</table>

Journals (in $)

(i) Allocation of profits to Y's NCI

DEBIT  Group retained earnings  22,300
CREDIT  NCI  22,300

to recognise the NCI share of Y's post-acquisition profits

(ii) Allocation of profits to Z's NCI

DEBIT  Group retained earnings  300
CREDIT  NCI  300

to recognise the NCI share of Z's post-acquisition profits
3  **Unrealised profit**

The unrealised profit of $2,000 ($4,000 \times \frac{1}{2}) arises from sales by the parent (downstream sales) and is therefore adjusted by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Inventory</th>
<th>$2,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CREDIT</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

DEBIT Group retained earnings 2,000 to adjust for the unrealised profit in inventory

4  **Intragroup amounts**

Both Antelope and Yak report a current account within assets; all three companies report liabilities due to group companies. These amounts are eliminated by ($):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>Inventory</th>
<th>$3,400</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBIT</td>
<td>Liability (Y)</td>
<td>$10,000</td>
</tr>
<tr>
<td>DEBIT</td>
<td>Liability (Z)</td>
<td>$12,600</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Current account (A)</td>
<td>$(5,200)</td>
</tr>
<tr>
<td>CREDIT</td>
<td>Current account (Y)</td>
<td>$(16,000)</td>
</tr>
</tbody>
</table>

5  **Consolidation schedule**

<table>
<thead>
<tr>
<th></th>
<th>Antelope</th>
<th>Yak</th>
<th>Zebra</th>
<th>W1(i)</th>
<th>W1(ii)</th>
<th>W2(i)</th>
<th>W2(ii)</th>
<th>W3</th>
<th>W4</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property</td>
<td>100</td>
<td>100</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>200</td>
</tr>
<tr>
<td>P&amp;M</td>
<td>210</td>
<td>80</td>
<td>3</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>293</td>
</tr>
<tr>
<td>Goodwill</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>5</td>
<td>0.2</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>5.2</td>
</tr>
<tr>
<td>Investments</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Shares</td>
<td>110</td>
<td>6.2</td>
<td>(110)</td>
<td>(6.2)</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Current account</td>
<td>10</td>
<td>16</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>200</td>
</tr>
<tr>
<td>Inventory</td>
<td>170</td>
<td>20.5</td>
<td>15</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>(2)</td>
<td>–</td>
<td>203.5</td>
</tr>
<tr>
<td>Receivables</td>
<td>140</td>
<td>50</td>
<td>1</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>191</td>
</tr>
<tr>
<td>Cash</td>
<td>60</td>
<td>16.5</td>
<td>4</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>80.5</td>
</tr>
<tr>
<td>Ord SC</td>
<td>200</td>
<td>100</td>
<td>10</td>
<td>(100)</td>
<td>(10)</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>200</td>
</tr>
<tr>
<td>Ret earn’gs</td>
<td>379.6</td>
<td>129.2</td>
<td>10</td>
<td>(100)</td>
<td>(10)</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>445.7</td>
</tr>
<tr>
<td>NCI</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>35</td>
<td>1.5</td>
<td>22.3</td>
<td>0.3</td>
<td>(2)</td>
<td>–</td>
<td>59.1</td>
</tr>
<tr>
<td>Payables</td>
<td>157</td>
<td>43</td>
<td>1.4</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>201.4</td>
</tr>
<tr>
<td>Due to A</td>
<td>–</td>
<td>10</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>(10)</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Due to Y</td>
<td>3.4</td>
<td>–</td>
<td>12.6</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>(16)</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Tax</td>
<td>60</td>
<td>7</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>67</td>
</tr>
</tbody>
</table>

**Total** 973.2
## ANTELOPE CO

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X4**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Non-current assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Freehold property</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Plant and machinery</td>
<td>293,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill (W1)</td>
<td>5,200</td>
<td></td>
</tr>
<tr>
<td></td>
<td>498,200</td>
<td></td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories $(205,500 – 2,000)</td>
<td>203,500</td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>191,000</td>
<td></td>
</tr>
<tr>
<td>Cash at bank</td>
<td>80,500</td>
<td></td>
</tr>
<tr>
<td></td>
<td>475,000</td>
<td></td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings (W5)</td>
<td>445,700</td>
<td></td>
</tr>
<tr>
<td>Shareholders' funds</td>
<td>645,700</td>
<td></td>
</tr>
<tr>
<td>Non-controlling interests (W5)</td>
<td>59,100</td>
<td></td>
</tr>
<tr>
<td></td>
<td>704,800</td>
<td></td>
</tr>
<tr>
<td><strong>Current liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade payables</td>
<td>201,400</td>
<td></td>
</tr>
<tr>
<td>Taxation</td>
<td>67,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>268,400</td>
<td></td>
</tr>
</tbody>
</table>

**27.4 ‘D’ shaped group**

Note: Panda comes into Hwee’s control on 1 January 20X4. As the investments in Panda by Hwee and Ming both happened on the same date, only one goodwill calculation is needed in respect of Panda.

- The direct non-controlling interest in Ming Ltd is 40%.
- The direct non-controlling interest in Panda Ltd is 20%.
- The indirect non-controlling interest in Panda Ltd is (40% of 60%) 24%.
- The total non-controlling interest in Panda Ltd is 44%.
- The group share of Ming Ltd is 60% and of Panda Ltd is (100 – 44)% = 56%.
Workings

1. Goodwill

<table>
<thead>
<tr>
<th></th>
<th>Hwee in Ming</th>
<th>Hwee and Ming in Panda</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred – direct</td>
<td>90,000</td>
<td>25,000</td>
</tr>
<tr>
<td>– indirect</td>
<td></td>
<td>25,200</td>
</tr>
<tr>
<td>Non-controlling interests</td>
<td>23,200</td>
<td>28,600</td>
</tr>
<tr>
<td>($58,000 × 40%)/($65,000 × 44%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fair value of NA acquired</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Share capital</td>
<td>8,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(58,000)</td>
<td>(65,000)</td>
</tr>
<tr>
<td></td>
<td>55,200</td>
<td>13,800</td>
</tr>
</tbody>
</table>

Journals (in $)

(i) Goodwill in M

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill in M</td>
<td>Share capital</td>
<td>NCI</td>
</tr>
<tr>
<td></td>
<td>50,000</td>
<td>23,200</td>
</tr>
<tr>
<td></td>
<td>Retained earnings</td>
<td>Investment in M</td>
</tr>
<tr>
<td></td>
<td>8,000</td>
<td>23,200</td>
</tr>
<tr>
<td>Goodwill in M</td>
<td>Goodwill</td>
<td>Investment in M</td>
</tr>
<tr>
<td></td>
<td>55,200</td>
<td>90,000</td>
</tr>
</tbody>
</table>

(ii) Goodwill in P

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill in P</td>
<td>Share capital</td>
<td>NCI</td>
</tr>
<tr>
<td></td>
<td>50,000</td>
<td>13,000</td>
</tr>
<tr>
<td></td>
<td>Retained earnings</td>
<td>Investment in P</td>
</tr>
<tr>
<td></td>
<td>15,000</td>
<td>67,000</td>
</tr>
<tr>
<td>Goodwill in P</td>
<td>Goodwill</td>
<td>Investment in P</td>
</tr>
<tr>
<td></td>
<td>15,000</td>
<td></td>
</tr>
</tbody>
</table>

Post-acquisition reserves

<table>
<thead>
<tr>
<th></th>
<th>Ming</th>
<th>Panda</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per question</td>
<td>32,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Pre-acquisition profits</td>
<td>(8,000)</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Post-acquisition retained earnings</td>
<td>24,000</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Ming's $20,000 revaluation surplus is all post-acquisition.

Amounts to be allocated to the NCI:

<table>
<thead>
<tr>
<th></th>
<th>Ming</th>
<th>Panda</th>
</tr>
</thead>
<tbody>
<tr>
<td>NCI's share in post-acquisition retained earnings ($24,000 × 40%)/($10,000 × 44%)</td>
<td>9,600</td>
<td>4,400</td>
</tr>
<tr>
<td>NCI's share in post-acquisition revaluation surplus ($20,000 × 40%)</td>
<td>8,000</td>
<td>–</td>
</tr>
<tr>
<td></td>
<td>17,600</td>
<td>4,400</td>
</tr>
</tbody>
</table>

Journals (in $)

(i) Allocation of profits to M's NCI

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group retained earnings</td>
<td>9,600</td>
<td></td>
</tr>
<tr>
<td>Group revaluation surplus</td>
<td>8,000</td>
<td></td>
</tr>
<tr>
<td>NCI</td>
<td></td>
<td>17,600</td>
</tr>
</tbody>
</table>

To recognise the NCI share of M's post-acquisition profits and revaluation surplus and eliminate the NCI share of M's investment in P
(ii) Allocation of profits to P’s NCI

DEBIT  Group retained earnings  4,400
CREDIT  NCI  4,400

to recognise the NCI share of P’s post-acquisition profits

3 Elimination of NCI interest in investment

The NCI interest in the investment in Panda in Ming’s books is $16,800 (40% × $42,000). This is eliminated by ($):

DEBIT  NCI  16,800
CREDIT  Investment in P  16,800

4 Consolidation schedule

<table>
<thead>
<tr>
<th></th>
<th>H</th>
<th>M</th>
<th>P</th>
<th>W1(i)</th>
<th>W1(ii)</th>
<th>W2(i)</th>
<th>W2(ii)</th>
<th>W3</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>NC assets</td>
<td>90</td>
<td>60</td>
<td>60</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>210</td>
</tr>
<tr>
<td>Inv in M</td>
<td>90</td>
<td>–</td>
<td>–</td>
<td>(90)</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Inv in P</td>
<td>25</td>
<td>42</td>
<td>–</td>
<td>–</td>
<td>(50.2)</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>(16,800)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>55.2</td>
<td>13.8</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>69</td>
</tr>
<tr>
<td>C assets</td>
<td>40</td>
<td>50</td>
<td>40</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>130</td>
</tr>
<tr>
<td>S capital</td>
<td>100</td>
<td>50</td>
<td>50</td>
<td>(50)</td>
<td>(50)</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>100</td>
</tr>
<tr>
<td>Rev surpl</td>
<td>45</td>
<td>32</td>
<td>25</td>
<td>(8)</td>
<td>(15)</td>
<td>(9.6)</td>
<td>(4.4)</td>
<td>–</td>
<td>65</td>
</tr>
<tr>
<td>R earnings</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>23.2</td>
<td>28.6</td>
<td>17.6</td>
<td>4.4</td>
<td>(16,800)</td>
<td>57</td>
</tr>
<tr>
<td>NCI</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>23.2</td>
<td>28.6</td>
<td>17.6</td>
<td>4.4</td>
<td>(16,800)</td>
<td>57</td>
</tr>
<tr>
<td>Loan</td>
<td>–</td>
<td>10</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>10</td>
</tr>
<tr>
<td>Payables</td>
<td>50</td>
<td>40</td>
<td>25</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>115</td>
</tr>
</tbody>
</table>

HWEE LTD
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MAY 20X5

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tangible assets</td>
<td>$210,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill (W1)</td>
<td>$69,000</td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>$409,000</td>
<td></td>
</tr>
</tbody>
</table>

| Equity and liabilities                  |       |
| Equity                                  |       |
| Ordinary share capital                 | $100,000  |
| Revaluation surplus (W3)               | $62,000   |
| Retained earnings (W3)                 | $65,000  |
| Shareholders' funds                    | $227,000  |
| Non-controlling interests (W3)         | $57,000   |
| Non-current liabilities                | $284,000  |
| 12% loan                               | $10,000   |
| Current liabilities                   | $294,000  |
| Payables                               | $115,000  |

Total assets: $409,000
Total equity and liabilities: $409,000
This chapter deals with two issues: step acquisitions (where control over a subsidiary is achieved in stages) and disposals. In each case there are special rules where control is held both before and after the transaction.

### Topic list

1. Step acquisitions
2. Disposals
1.1 Types of business combination achieved in stages

There are three possible types of business combinations achieved in stages:

(a) A previously held interest, say 10%, with no significant influence (accounted for under SFRS(I) 9) is increased to a controlling interest.

(b) A previously held interest, say 35%, accounted for as an associate or joint venture under SFRS(I) 1-28, or as a joint operation under SFRS(I) 11 (provided that the joint operation meets the SFRS(I) 3 definition of a business), is increased to a controlling interest.

(c) A controlling interest in a subsidiary is increased, say from 60% to 80%.

The first two transactions are treated in the same way, but the third is not. This is because control is not achieved until the shareholding is increased in (a) and (b), whereas control was already established in (c) prior to the increase in shareholding. Control is a key term that you should consider again (see SFRS(I) 10 paragraphs 5–7).
1.1.1 General principle: ‘crossing an accounting boundary’

Under SFRS(I) 3 a business combination occurs only when one entity obtains control over another. This can be referred to as ‘crossing an accounting boundary’. This chapter assumes that an entity controls another when more than 50% of the equity share capital is acquired. You should be aware that the definition of control in SFRS(I) 10 does not refer to percentage holdings, but to power and rights, and therefore this assumption is a simplification of the SFRS(I) 10 requirements and is made for illustrative purposes only.

When one entity obtains control over another, the original equity investment – whether an investment under SFRS(I) 9 with no significant influence, or an associate – is treated as if it were disposed of at fair value and re-acquired at fair value. This previously held interest at fair value, together with any consideration transferred, is the ‘cost’ of the combination used in calculating the goodwill.

If the ‘Control’ boundary is not crossed, as when the equity interest in a subsidiary is increased, the event is treated as a transaction between owners.

The following diagram may help you visualise the boundary:

![Diagram of accounting boundaries]

As you will see from the diagram, the third situation in paragraph 1.1, where an equity interest in an existing subsidiary is increased, does not involve crossing that all-important ‘control boundary’. Likewise, purchases in which control is not achieved do not involve crossing the boundary, and therefore do not trigger a calculation of goodwill.

Note that where an existing financial asset investment or associate investment is increased, however control is not achieved, there is no business combination. In these cases the cost of the additional investment is added to the carrying amount of the previously held investment.

1.2 Calculation of goodwill when control is achieved in stages

Where control is achieved in stages, the previously held investment is treated as if it were sold at fair value and then repurchased at fair value. The net effect of this is that the previous investment is revalued to fair value and a gain or loss recognised:

(a) In accordance with SFRS(I) 9 Financial Instruments if the previously held investment was a financial asset; or

(b) In profit or loss if the previously held shareholding was an associate or joint arrangement.

Where the previously held interest was a joint operation, the interest to be remeasured includes any unrecognised assets, liabilities and goodwill relating to the joint operation.
Goodwill is then calculated as follows (note this is as previously seen in Chapter 24 but with the addition that the consideration is enhanced by the fair value of the previously held interest):

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of consideration transferred</td>
<td>X</td>
</tr>
<tr>
<td>Fair value of acquirer's previously held equity interest</td>
<td>X</td>
</tr>
<tr>
<td>Non-controlling interest (at %FV of net assets or fair value)</td>
<td>X</td>
</tr>
<tr>
<td>Less fair value of identifiable net assets acquired and liabilities assumed</td>
<td>(X)</td>
</tr>
<tr>
<td>Goodwill/bargain purchase</td>
<td>X</td>
</tr>
</tbody>
</table>

1.2.1 Analogy: trading in a small car for a larger one

It may seem counter-intuitive that the previous investment is now part of the 'cost' for the purposes of calculating the goodwill. One way of looking at it is to imagine that you are trading-in a small car for a larger one. The value of the car you trade in is put towards the cost of the new vehicle, together with your cash (the 'consideration transferred'). Likewise, the company making the acquisition has part-exchanged its smaller investment – at fair value – for a larger one, and must naturally pay on top of that to obtain the larger investment.

This analogy is not exact, but may help. The consideration given for the new investment, plus the old investment, plus the remaining non-controlling investment is the whole of the business and this is compared to the whole of the fair value of the net assets of the business to obtain goodwill.

Try the following question to get the hang of the calculation of goodwill and profit on derecognition of the investment.

**Question 28.1**

Tampines Green Ltd, whose year-end is 30 June 20X9 has a subsidiary, Woodward Pte Ltd, which it acquired in stages. The details of the acquisition are as follows.

<table>
<thead>
<tr>
<th>Date of acquisition</th>
<th>Holding acquired %</th>
<th>Retained earnings at acquisition $m</th>
<th>Purchase consideration $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 July 20X7</td>
<td>20</td>
<td>270</td>
<td>120</td>
</tr>
<tr>
<td>1 July 20X8</td>
<td>60</td>
<td>450</td>
<td>480</td>
</tr>
<tr>
<td></td>
<td>80</td>
<td></td>
<td>600</td>
</tr>
</tbody>
</table>

The share capital of Woodward has remained unchanged since its incorporation at $300 million. The fair values of the net assets of Woodward were the same as their carrying amounts at the date of the acquisition. Tampines Green did not have significant influence over Woodward at any time before gaining control of the company and measured its investment at fair value through profit or loss. The group policy is to measure non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets. The fair value of the investment in Woodward was $160 million at 30 June 20X8.

**Required**

(a) Calculate the goodwill on the acquisition of Woodward that will appear in the consolidated statement of financial position at 30 June 20X9.

(b) Calculate the profit on the derecognition of any previously held investment in Woodward to be reported in group profit or loss for the year ended 30 June 20X9.
1.3 Preparation of consolidated financial statements

1.3.1 Financial asset becomes a subsidiary

Where a financial asset becomes a subsidiary:

(a) The investment is consolidated in the statement of financial position based on the year-end shareholding, with goodwill recognised on the acquisition

(b) Dividend income and changes in fair value are shown in the consolidated statement of profit or loss and other comprehensive income until control is achieved; thereafter the results are consolidated

In the statement of profit or loss and other comprehensive income:

(a) Recognise gain or loss on derecognition of financial asset in profit or loss (fair value at date control achieved less carrying value)

1.3.2 Associate or joint arrangement becomes a subsidiary

Where an associate or joint arrangement becomes a subsidiary:

(a) Again, the investment is consolidated in the statement of financial position based on the year-end shareholding, with goodwill recognised on the acquisition

(b) An associate or joint venture is equity accounted in the consolidated statement of profit or loss and other comprehensive income until control is achieved; thereafter the results are consolidated.

(c) A joint operation is accounted for in accordance with SFRS(I) 11 until control is achieved; thereafter the results are consolidated

Example

Orchard Electrical acquired 25% of Yeo Electrical's 800,000 shares on 1 January 20X1 for $2,020,000 when Yeo Electrical's reserves were standing at $5,800,000. The fair value of Yeo Electrical's identifiable assets less liabilities at that date was $7,200,000. Both Orchard and Yeo Electrical are stock market listed entities.

At 31 December 20X1, the fair value of Orchard Electrical's 25% stake in Yeo Electrical was $2,440,000.

A further 35% stake in Yeo Electrical was acquired by Orchard Electrical on 30 September 20X2 for $4,025,000 (equivalent to the fair value of $14.375 per share acquired on that date) giving Orchard Electrical control over Yeo Electrical. The fair value of Yeo Electrical's identifiable assets less liabilities at that date was $9,400,000, and Yeo Electrical's reserves stood at $7,800,000.

For consistency with the measurement of other shares, Orchard Electrical holds all investments in subsidiaries and associates as financial assets in its separate financial statements as permitted by SFRS(I) 1-27. As these investments are not held for trading, Orchard Electrical elects to measure them at fair value through other comprehensive income in accordance with SFRS(I) 9.

At 31 December 20X2, the fair value of Orchard Electrical's 60% holding in Yeo Electrical was $7,020,000 and total cumulative gains recognised in other comprehensive income in Orchard Electrical's separate financial statements amounted to $975,000.
Summarised statements of financial position of the two companies at 31 December 20X2 show:

<table>
<thead>
<tr>
<th></th>
<th>Orchard Electrical $'000</th>
<th>Yeo Electrical $'000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-current assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>38,650</td>
<td>7,600</td>
</tr>
<tr>
<td>Investment in Yeo Electrical</td>
<td>7,020</td>
<td>–</td>
</tr>
<tr>
<td></td>
<td>45,670</td>
<td>7,600</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>12,700</td>
<td>2,200</td>
</tr>
<tr>
<td></td>
<td>58,370</td>
<td>9,800</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>10,200</td>
<td>800</td>
</tr>
<tr>
<td>Reserves</td>
<td>40,720</td>
<td>7,900</td>
</tr>
<tr>
<td></td>
<td>50,920</td>
<td>8,700</td>
</tr>
<tr>
<td>Liabilities</td>
<td>7,450</td>
<td>1,100</td>
</tr>
<tr>
<td></td>
<td>58,370</td>
<td>9,800</td>
</tr>
</tbody>
</table>

SUMMARISED STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR TO 31 DECEMBER 20X2

<table>
<thead>
<tr>
<th></th>
<th>Orchard Electrical $'000</th>
<th>Yeo Electrical $'000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Profit before interest and tax</strong></td>
<td>1,280</td>
<td>420</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(80)</td>
<td>(20)</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>1,200</td>
<td>400</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(360)</td>
<td>(80)</td>
</tr>
<tr>
<td><strong>PROFIT FOR THE YEAR</strong></td>
<td>840</td>
<td>320</td>
</tr>
<tr>
<td><strong>Other comprehensive income (items that will not be reclassified to profit or loss):</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain on property valuation, net of tax</td>
<td>240</td>
<td>80</td>
</tr>
<tr>
<td><strong>Other comprehensive income (items that will be reclassified to profit or loss):</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain on investment in Yeo Electrical</td>
<td>555</td>
<td>–</td>
</tr>
<tr>
<td><strong>Other comprehensive income for the year, net of tax</strong></td>
<td>795</td>
<td>80</td>
</tr>
<tr>
<td><strong>TOTAL COMPREHENSIVE INCOME FOR THE YEAR</strong></td>
<td>1,635</td>
<td>400</td>
</tr>
</tbody>
</table>

The difference between the fair value of the identifiable assets and liabilities of Yeo Electrical and their book value relates to the value of a plot of land. The land had not been sold by 31 December 20X2.

Income and expenses are assumed to accrue evenly over the year. Neither company paid dividends during the year.

Orchard Electrical elected to measure non-controlling interests at the date of acquisition at fair value. No impairment losses on recognised goodwill have been necessary to date.

**Required**

Prepare the consolidated statement of profit or loss and other comprehensive income and statement of financial position of the Orchard Electrical Group as at 31 December 20X2 in the following circumstances:

(a) The 25% interest in Yeo Electrical allowed Orchard Electrical significant influence over the financial and operating policy decisions of Yeo Electrical

(b) The other 75% of shares were held by a single shareholder and Orchard Electrical was allowed no influence in the running of Yeo Electrical until acquiring control
## Solution

(a) ORCHARD ELECTRICAL GROUP

### CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-current assets</strong></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>47,050</td>
</tr>
<tr>
<td>Goodwill</td>
<td>2,100</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>49,150</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
</tr>
<tr>
<td>(12,700 + 2,200)</td>
<td>14,900</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>64,050</td>
</tr>
<tr>
<td><strong>Equity attributable to owners of the parent</strong></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>10,200</td>
</tr>
<tr>
<td>Reserves (W3)</td>
<td>40,660</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>50,860</td>
</tr>
<tr>
<td><strong>Non-controlling interests</strong> (W4)</td>
<td></td>
</tr>
<tr>
<td>(W4)</td>
<td>4,640</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>55,500</td>
</tr>
<tr>
<td><strong>Liabilities</strong> (7,450 + 1,100)</td>
<td></td>
</tr>
<tr>
<td>(7,450 + 1,100)</td>
<td>8,555</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>64,050</td>
</tr>
</tbody>
</table>

### CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before interest and tax (1,280 + (420 \times 3/12))</td>
<td>1,385</td>
</tr>
<tr>
<td>Finance costs (80 + (20 \times 3/12))</td>
<td>(85)</td>
</tr>
<tr>
<td>Profit on derecognition of associate (W3)</td>
<td>355</td>
</tr>
<tr>
<td>Share of profit of associate (320 \times 9/12 \times 25%)</td>
<td>60</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>1,715</td>
</tr>
<tr>
<td>Income tax expense (360 + (80 \times 3/12))</td>
<td>(380)</td>
</tr>
<tr>
<td><strong>PROFIT FOR THE YEAR</strong></td>
<td>1,335</td>
</tr>
<tr>
<td><strong>Other comprehensive income (items that will not be reclassified to profit or loss):</strong></td>
<td></td>
</tr>
<tr>
<td>Gains on property revaluation, net of tax (240 + (80 \times 3/12))</td>
<td>260</td>
</tr>
<tr>
<td>Share of other comprehensive income of associate (80 \times 9/12 \times 25%)</td>
<td>15</td>
</tr>
<tr>
<td><strong>Other comprehensive income for the year, net of tax</strong></td>
<td>275</td>
</tr>
<tr>
<td><strong>TOTAL COMPREHENSIVE INCOME FOR THE YEAR</strong></td>
<td>1,610</td>
</tr>
</tbody>
</table>

Profit attributable to:
- Owners of parent | 1,303
- Non-controlling interests (320 \times 3/12 \times 40%) | 32
- **Total**        | 1,335

Total comprehensive income attributable to:
- Owners of parent | 1,570
- Non-controlling interests (400 \times 3/12 \times 40%) | 40
- **Total**        | 1,610
Workings

1. **Group structure**

<table>
<thead>
<tr>
<th>Orchard Electrical</th>
<th>1.1.20X1</th>
<th>30.9.20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>25%</td>
<td>35%</td>
</tr>
<tr>
<td>Pre-acq’n reserves</td>
<td>$2.02m</td>
<td>$4.025m</td>
</tr>
<tr>
<td></td>
<td>$5.8m</td>
<td>$7.8m</td>
</tr>
</tbody>
</table>

   **Yeo Electrical**

   Timeline for 20X2

   - 1.1.X2
   - 30.9.X2
   - 31.12.X2

   **SPLOCI**

   **Associate – Equity accounting × 9/12**

   **Consolidate × 3/12**

   Had 25% associate

   Acquired 35%

   25% + 35% = 60% Subsidiary

   **Consolidated reserves (if previously held as an associate)**

<table>
<thead>
<tr>
<th>Orchard Electrical</th>
<th>Yeo Electrical</th>
<th>Yeo Electrical</th>
</tr>
</thead>
<tbody>
<tr>
<td>$’000</td>
<td>25% $’000</td>
<td>60% $’000</td>
</tr>
</tbody>
</table>

   - Per question/at date control obtained/at reporting date
   - Profit on derecognition of investment *
   - Fair value movement (W5)
   - Reserves at acquisition
   - Group share of post-acquisition reserves:
   - Yeo Electrical – 25% (2,000 × 25%)
   - Yeo Electrical – 60% (100 × 60%)
   - Less fair value gain recognised in Orchard Electrical's separate FS

<table>
<thead>
<tr>
<th>Orchard Electrical</th>
<th>Yeo Electrical</th>
<th>Yeo Electrical</th>
</tr>
</thead>
<tbody>
<tr>
<td>$’000</td>
<td>7,800</td>
<td>7,900</td>
</tr>
<tr>
<td>40,720</td>
<td>355</td>
<td></td>
</tr>
<tr>
<td>(5,800)</td>
<td>(7,800)</td>
<td>2,000</td>
</tr>
<tr>
<td>500</td>
<td>60</td>
<td>(975)</td>
</tr>
<tr>
<td>40,660</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
* Profit on derecognition of 25% associate

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value at date control obtained (200,000 shares × $14.375)</td>
<td>2,875</td>
</tr>
<tr>
<td>O's share of carrying amount [2,020 + ((7,800 – 5,800) × 25%)]</td>
<td>(2,520)</td>
</tr>
<tr>
<td></td>
<td>355</td>
</tr>
</tbody>
</table>

Note: The total fair value gain on the investment recognised by Orchard Electrical since acquisition is $975, calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Gain</th>
<th>Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of 25% shareholding</td>
<td>2,020</td>
<td>2,020</td>
</tr>
<tr>
<td>Fair value gain to 31/12/20X1</td>
<td>420</td>
<td>420</td>
</tr>
<tr>
<td>Fair value at 31/12/20X1 carrying amount at 30/9/20X2</td>
<td>2,440</td>
<td>2,440</td>
</tr>
<tr>
<td>Cost of additional 35% at 30/9/20X2</td>
<td>4,025</td>
<td>4,025</td>
</tr>
<tr>
<td>Fair value gain to 31/12/20X2</td>
<td>555</td>
<td>555</td>
</tr>
<tr>
<td>Carrying amount at reporting date</td>
<td>7,020</td>
<td>7,020</td>
</tr>
</tbody>
</table>

4 **Non-controlling interests**

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>NCI at acquisition (W2)</td>
<td>4,600</td>
</tr>
<tr>
<td>NCI share of reserves post control:</td>
<td></td>
</tr>
<tr>
<td>Yeo Electrical – 40% ((W3) 100 × 40%)</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>4,640</td>
</tr>
</tbody>
</table>

5 **Fair value adjustments**

<table>
<thead>
<tr>
<th></th>
<th>At acquisition 30.9.X2</th>
<th>Movement $000</th>
<th>At year-end 31.12.X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land (9,400 – (800 + 7,800))</td>
<td>800</td>
<td>–</td>
<td>800</td>
</tr>
</tbody>
</table>

(b) Part (b) will generate the same overall answer for the statement of financial position as part (a) (see W7 for difference in proof of reserves).

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2**

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-current assets</strong></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>47,050</td>
</tr>
<tr>
<td>Goodwill</td>
<td>2,100</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>14,900</td>
</tr>
<tr>
<td><strong>Equity attributable to owners of the parent</strong></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>10,200</td>
</tr>
<tr>
<td>Reserves (W7)</td>
<td>40,660</td>
</tr>
<tr>
<td><strong>Non-controlling interests</strong></td>
<td>4,640</td>
</tr>
<tr>
<td></td>
<td>55,500</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>8,550</td>
</tr>
<tr>
<td></td>
<td>64,050</td>
</tr>
</tbody>
</table>
The statement of profit or loss and other comprehensive income however will report different figures:

**CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME**

FOR THE YEAR ENDED 31 DECEMBER 20X2

<table>
<thead>
<tr>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before interest and tax ((1,280 + (420 \times 3/12)))</td>
</tr>
<tr>
<td>Finance costs ((80 + (20 \times 3/12)))</td>
</tr>
<tr>
<td>Profit on derecognition of financial asset ((W7))</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
</tr>
<tr>
<td>Income tax expense ((360 + (80 \times 3/12)))</td>
</tr>
<tr>
<td><strong>PROFIT FOR THE YEAR</strong></td>
</tr>
<tr>
<td><strong>Other comprehensive income (items that will not be reclassified to profit or loss):</strong></td>
</tr>
<tr>
<td>Gains on property revaluation, net of tax ((240 + (80 \times 3/12)))</td>
</tr>
<tr>
<td><strong>Other comprehensive income for the year, net of tax</strong></td>
</tr>
<tr>
<td><strong>TOTAL COMPREHENSIVE INCOME FOR THE YEAR</strong></td>
</tr>
</tbody>
</table>

Profit attributable to:

- Owners of parent \((\beta)\) | 1,323 |
- Non-controlling interests \((320 \times 3/12 \times 40\%\) | 32 |
**Total comprehensive income attributable to:**

- Owners of parent \((\beta)\) | 1,355 |
- Non-controlling interests \((400 \times 3/12 \times 40\%\) | 40 |
**1,615**

**Workings (cont'd)**

6 **Timeline for 20X2**

<table>
<thead>
<tr>
<th>1.1.X2</th>
<th>30.9.X2</th>
<th>31.12.X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPLOCI</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Had 25% financial asset</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquired 35% 25% + 35% = 60% Subsidiary</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consol in SOFP with 40% NCI</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

7 **Consolidated reserves (if previously held as at FVTOCI) – proof**

<table>
<thead>
<tr>
<th>Orchard Electrical $’000</th>
<th>Yeo Electrical $’000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Per question</strong></td>
<td>40,720</td>
</tr>
<tr>
<td>Profit on 25% investment*</td>
<td>435</td>
</tr>
<tr>
<td>Fair value movement (part (a) ((W5)))</td>
<td>(0)</td>
</tr>
<tr>
<td>Reserves at acquisition</td>
<td>(7,800)</td>
</tr>
</tbody>
</table>

Group share of post-acquisition reserves:

- Yeo Electrical \((100 \times 60\%)\) | 60 |
- Less Fair value gain recognised in Orchard Electrical's separate FS since acquisition | (555) |

**40,660**
1.4 Step acquisitions where control is retained

An example of an acquisition where control is retained would be where an investment goes from a 60% subsidiary to an 80% subsidiary.

Where the controlling interest increases from 60% to 80%, the investment was under the control of the parent company to start with and remains under its control.

Goodwill is not therefore recalculated and the original investment is not re-measured to fair value. Instead the increase in the parent’s shareholding is treated as a transaction between owners.

Accordingly the parent’s equity, in the consolidated statement of financial position, is adjusted. SFRS(I) 10 does not provide detailed guidance as to how to measure the adjustment, but an acceptable approach is to calculate it as the difference between the fair value of consideration paid and the decrease in non-controlling interest. (As the parent’s share has increased, the NCI share has decreased.)

\[
\text{Fair value of consideration} \times \text{Decrease in NCI in net assets at date of transaction} \times \text{Decrease in NCI in goodwill at date of transaction} \times \text{Adjustment to parent’s equity}
\]

Note: This line is only required where non-controlling interests are measured at fair value at the date of acquisition (i.e. where there is a decrease in the non-controlling interest share of goodwill already recognised).

No fair value adjustments to the subsidiary are required as the original investment has not been sold (or deemed to have been sold).

Example

A Ltd has owned 70% of B Ltd for a number of years. On 1 February 20X6, A Ltd increases its shareholding to 90% at a cost of $2.5 million. The net assets of B Ltd on this date are $10 million and the non-controlling interest is measured as a proportion of net assets.

What consolidation adjustment is required on the acquisition?

Solution

\[
\begin{align*}
\text{Fair value of consideration} & \quad 2,500 \\
\text{Decrease in NCI 20% } \times \text{10m} & \quad 2,000 \\
\text{Adjustment to parent’s equity} & \quad 500
\end{align*}
\]
The required journal is ($’000):

<table>
<thead>
<tr>
<th>Debit</th>
<th>2,000</th>
<th>500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity – non-controlling interests</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity – controlling interest</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

to record the increase in shareholding in B Ltd

**Example**

The facts are as the example above, but A Ltd measures the non-controlling interest in B Ltd at fair value and the carrying amount of the NCI at 1 February 20X6 is $3.4m.

What adjustment is required on the acquisition?

**Solution**

Here the goodwill attributable to the NCI must be $400,000 ie the difference between the $3.4m carrying amount of NCI and the NCI in net assets (pre-acquisition) of $3m (30% × $10m).

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of consideration</td>
<td>2,500</td>
</tr>
<tr>
<td>Decrease in NCI in net assets</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Decrease in NCI in goodwill (20/30 × $400)</td>
<td>(267)</td>
</tr>
<tr>
<td>Adjustment to parent's equity</td>
<td>233</td>
</tr>
</tbody>
</table>

The required journal is ($’000):

<table>
<thead>
<tr>
<th>Debit</th>
<th>2,267</th>
<th>233</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity – non-controlling interests</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity – controlling interest</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

to record the increase in shareholding in B Ltd

As evidenced by these two examples, the adjustment to parent's equity on the acquisition of more shares in a subsidiary is less where the NCI is measured at fair value and includes NCI goodwill.

**1.5 Achieving joint control**

An entity that participates in, but does not have joint control, of, a joint operation may subsequently obtain joint control. In this case SFRS(I) 11 clarifies that previously held interests are not remeasured.

**SECTION SUMMARY**

Where control is achieved in stages:

- Any previously held equity interest is re-measured to **fair value at the date control is achieved**
- Any **gain is reported in profit or loss or in accordance with SFRS(I) 9** if the previously held interest was a financial asset
- Goodwill is calculated as the sum of consideration transferred plus the non-controlling interest plus the fair value of the previously held investment less the fair value of identifiable net assets acquired.

Where a parent company increases its shareholding in a company that is already a subsidiary, goodwill is not recalculated; the transaction is recognised in parent's equity.
2 Disposals

SECTION INTRODUCTION

Disposals can drop a subsidiary holding to associate status, long-term investment status or to zero, or the parent might still retain a subsidiary with a reduced holding.

2.1 Disposal of shares in a subsidiary

Disposals of shareholdings in a subsidiary may take the form of:

(a) Full disposal: all the holding is sold (eg 80% to nil)
(b) Subsidiary to financial asset investment (eg 80% to 10%)
(c) Subsidiary to associate (eg 80% to 30%)
(d) Subsidiary to subsidiary (eg 80% to 60%)

As with step acquisitions, the accounting treatment differs depending on whether the 50% ownership level is crossed and so control is lost.

2.2 General principle: 'crossing an accounting boundary'

Under SFRS(I) 10 a gain or loss on disposal of shares in a subsidiary is recognised only when the parent loses control of the subsidiary. Again, for illustrative purposes only, within this chapter we shall assume that this happens when one entity’s shareholding in another is decreased to 50% or less.

On disposal of a controlling interest, any retained interest (an associate or financial asset investment) is measured at fair value on the date that control is lost. This fair value is used in the calculation of the gain or loss on disposal, and also becomes the carrying amount for subsequent accounting for the retained interest.

If the 'control boundary' is not crossed, as when the interest in a subsidiary is reduced but control is maintained, the event is treated as a transaction between owners.

The following diagram may help you visualise the boundary:

As you will see from the diagram where an interest in a subsidiary is reduced, but control maintained, this does not involve crossing that all-important ‘control boundary’.
2.3 Effective date of disposal
The effective date of disposal is when control passes: the date for accounting for and ceasing to be a subsidiary is the date on which its former parent relinquishes its control over that undertaking. The consolidated statement of profit or loss and other comprehensive income should include the results of a subsidiary undertaking up to the date of its disposal.

2.4 Full disposal
Where all of the shareholding in a subsidiary is disposed of, a gain or loss on disposal is recognised in both the parent's individual and the consolidated financial statements.

2.4.1 Gain or loss in parent company's accounts
The gain or loss in the parent company's individual accounts is calculated as:

\[
\text{Gain/(loss) on disposal} = \frac{\text{Fair value of consideration received}}{} \times \frac{\text{Carrying amount of investment disposed of}}{} - \text{Gain/(loss) on disposal}
\]

2.4.2 Gain or loss in consolidated accounts
The gain or loss on disposal in the consolidated accounts is calculated differently because the carrying amount of the investment is based on the subsidiary's net assets, any goodwill and the non-controlling interest:

\[
\text{Gain/(loss) on disposal} = \frac{\text{Fair value of consideration received}}{} - \text{Net assets of subsidiary at disposal date*} - \text{Goodwill at disposal date**} - \text{Non-controlling interest at disposal date} \times \text{Gain/(loss) on disposal}
\]

* This would include any remaining fair value effects included at acquisition
** Goodwill at acquisition less any subsequent impairment

2.4.3 Preparation of consolidated financial statements
When preparing the consolidated financial statements following a full disposal the following procedures must be followed:

\* Statement of financial position
- The subsidiary's net assets, goodwill and non-controlling interest are de-recognised

\* Statement of profit or loss and other comprehensive income
(a) The results of the subsidiary are consolidated up until the disposal date
(b) The non-controlling interest in profit and total comprehensive income is calculated based on pro-rated amounts until control is lost
(c) The group gain on disposal replaces the parent's individual gain on disposal
(d) If the subsidiary meets the SFRS(I) 5 Non-current Assets Held For Sale and Discontinued Operations definition of a discontinued operation then the group profit on disposal plus the subsidiary's profit or loss until disposal are included in one line 'profit for the period from discontinued operations'

2.5 Subsidiary to financial asset investment
In this situation a gain (or loss) is again recognised in the parent's individual accounts and a group gain (or loss) is recognised in the consolidated accounts.
The gain (or loss) in the individual parent company accounts is calculated in the same way as we have seen, but this time the group gain on disposal is slightly different.

2.5.1 Calculation of group gain on disposal

A proforma calculation is shown below:

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of consideration received</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Fair value of any investment retained</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Less: share of consolidated carrying amount at date control lost:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>net assets</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>goodwill</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>less non-controlling interests</td>
<td>(X)</td>
<td>(X)</td>
</tr>
</tbody>
</table>

Add/less: gains/(losses) previously recognised in other comprehensive income*

* This will only arise on items such as foreign exchange differences on the translation of subsidiaries (see Chapter 29)

Note how the fair value of the investment retained forms part of the calculation.

It may seem counter-intuitive that the investment retained is now part of the ‘proceeds’ for the purposes of calculating the gain. As explained earlier, one way of looking at it is to imagine that you are selling a larger car and putting part of the proceeds towards a smaller one. If the larger car you are selling cost you less than the smaller car and cash combined, you have made a profit. Likewise, the company making the disposal sold a larger stake to gain, at fair value, a smaller stake and some cash on top, which is the ‘consideration received’.

The group gain or loss on disposal is therefore made up of two elements:

1. A realised gain or loss on the shares disposed of; and
2. An unrealised gain or loss on the shares retained.

2.5.2 Preparation of consolidated financial statements

In the **Statement of financial position**

- The investment is recognised at its fair value at the date of disposal.
- Thereafter, it is accounted for in accordance with SFRS(I) 9.

In the **Statement of profit or loss and other comprehensive income**

- The results of the investment are consolidated up to the date of disposal.
- Show dividend income only thereafter
- The group gain or loss on disposal replaces the parent company gain or loss on disposal.

2.6 Subsidiary to associate

In this situation control is lost (the subsidiary is deemed to have been disposed of and the retained interest repurchased at fair value) and therefore:

(a) A parent company gain or loss calculated as seen in section 2.4.1 is recognised
(b) A group gain or loss on disposal calculated as seen in section 2.5.1 is recognised

2.6.1 Preparation of consolidated financial statements

In the **Statement of financial position**

- The investment is recognised at its fair value at the date of disposal
Thereafter, it is equity accounted for in accordance with SFRS(I) 1-28 *Investments in Associates and Joint Ventures*.

In the **Statement of profit or loss and other comprehensive income**

- The results of the investment are consolidated up to the date of disposal
- It is equity accounted for thereafter
- The group gain or loss on disposal replaces the parent company gain or loss on disposal

### 2.7 Reduction in holding of a subsidiary

Control is retained where the disposal is from subsidiary to subsidiary. The accounting treatment is as follows.

In the **statement of financial position**:

(a) The non-controlling interest in the statement of financial position is based on the year-end percentage.
(b) The change (increase) in non-controlling interests is shown as an adjustment to the parent's equity.
(c) Goodwill on acquisition is unchanged in the consolidated statement of financial position.

In the **statement of profit or loss and other comprehensive income**:

(a) The subsidiary is **consolidated in full** for the whole period.
(b) The **non-controlling interest in the statement of profit or loss** will be based on the percentage before and after disposal, ie time apportion.
(c) There is no profit or loss on disposal.

#### 2.7.1 Adjustment to the parent's equity

The adjustment to the parent's equity reflects the fact that the non-controlling share has increased (as the parent's share has reduced). A partial disposal of a subsidiary is, in effect, a transaction between owners. Specifically, it is a reallocation of ownership between parent and non-controlling equity holders. The adjustment to the parent's equity may be calculated as follows.

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of consideration received</td>
<td>$X</td>
</tr>
<tr>
<td>Increase in NCI in net assets at disposal</td>
<td>$(X)</td>
</tr>
<tr>
<td>Increase in NCI in goodwill at disposal</td>
<td>$(X)</td>
</tr>
<tr>
<td>Adjustment to parent's equity</td>
<td>$X</td>
</tr>
</tbody>
</table>

Note: This line is only required where non-controlling interests are measured at fair value at the date of acquisition (ie where there is an increase in the non-controlling interest share of goodwill already recognised).

### 2.8 Examples of disposals of shares in a subsidiary

**Example**

C Ltd bought 100% of the voting share capital of D Ltd on its incorporation on 1 January 20X2 for $160,000. D Ltd earned and retained $240,000 from that date until 31 December 20X7. At that date D Ltd's net assets were $400,000. In its separate financial statements, C Ltd accounts for its investments at cost.

It is the group's policy to measure the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

On 1 January 20X8 C Ltd sold 40% of its shareholding in D Ltd for $280,000.

What is the parent gain on disposal and what adjustment is made to the consolidated accounts?
Solution

The profit on disposal (ignoring tax) in the financial statements of the parent company is calculated as follows.

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of consideration received</td>
<td>280</td>
</tr>
<tr>
<td>Carrying amount of investment ((40% \times 160))</td>
<td>64</td>
</tr>
<tr>
<td>Profit on sale</td>
<td>216</td>
</tr>
</tbody>
</table>

Journal ($’000)

- **DEBIT** Cash 280
- **CREDIT** Investment 64
- **CREDIT** Profit on sale 216

to derecognise the disposed of shareholding and recognise a gain on disposal

In the consolidated accounts, the adjustment to parent’s equity is calculated as follows.

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of consideration received</td>
<td>280</td>
</tr>
<tr>
<td>Increase in non-controlling interest in net assets at the date of disposal ((40% \times 400))</td>
<td>160</td>
</tr>
<tr>
<td>Adjustment to parent’s equity</td>
<td>120</td>
</tr>
</tbody>
</table>

Journals ($’000)

- **DEBIT** Cash 280
- **CREDIT** NCI 160
- **CREDIT** Parent’s equity (retained earnings) 120

to recognise the adjustment to equity on part-disposal

Note that there is no goodwill in this example, or non-controlling interest in goodwill, as the subsidiary was acquired on incorporation.

Therefore, assuming that the parent has recorded the disposal in its own accounts, on consolidation, the following adjustment is required ($’000):

- **DEBIT** Investment 64
- **DEBIT** Profit on sale 216
- **CREDIT** NCI 160
- **CREDIT** Parent’s equity (retained earnings) 120

to reverse the disposal entries in the parent’s books and record the adjustment to equity at group level

It may seem odd to reinstate the investment as part of the consolidation adjustment, but remember that goodwill is unchanged on a disposal where control is not lost and the consolidation journal to recognise goodwill will therefore remove the whole $160,000 investment in D.
Example

Using the above example, assume that C Ltd sold 60% of its holding in D Ltd for $440,000. The fair value of the 40% holding retained was $200,000. The gain or loss on disposal in the books of the parent company would be calculated as follows.

<table>
<thead>
<tr>
<th>Parent company</th>
</tr>
</thead>
<tbody>
<tr>
<td>$'000</td>
</tr>
<tr>
<td>Fair value of consideration received</td>
</tr>
<tr>
<td>Carrying amount of investment (60% × 160)</td>
</tr>
<tr>
<td>Profit on sale</td>
</tr>
</tbody>
</table>

Journal ($'000)

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Investment</td>
</tr>
<tr>
<td>440</td>
<td>96</td>
</tr>
</tbody>
</table>

to derecognise the disposed of shareholding and recognise a gain on disposal

This time control is lost, so in the consolidated accounts there will be a gain in group profit or loss, calculated as follows.

<table>
<thead>
<tr>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of consideration received</td>
</tr>
<tr>
<td>Fair value of investment retained</td>
</tr>
<tr>
<td>Less carrying amount of net assets at date of control loss</td>
</tr>
<tr>
<td>Group profit on sale</td>
</tr>
</tbody>
</table>

Consolidation adjustment journal

Again, assuming that the parent company has recorded the disposal in its own accounts, adjustment is required to reach the consolidated position whereby:

- The investment is recognised at fair value
- The group gain rather than company gain is included
- The post-acquisition profits of D Ltd attributable to C Ltd are included in reserves

This is achieved by ($'000):

<table>
<thead>
<tr>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit on sale (344 – 240)</td>
<td>104</td>
</tr>
<tr>
<td>Investment in associate (200 – (40% × 160))</td>
<td>136</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>240</td>
</tr>
</tbody>
</table>

Question 28.2 Disposal

Balestier Co bought 80% of the share capital of Woodlands Co for $324,000 on 1 October 20X5. At that date Woodlands Co's retained earnings balance stood at $180,000. The statements of financial position at 30 September 20X8 and the summarised statements of profit or loss to that date are given below. (There is no other comprehensive income.)

<table>
<thead>
<tr>
<th>Balestier Co</th>
<th>Woodlands Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Non-current assets</td>
<td>360</td>
</tr>
<tr>
<td>Investment in Woodlands Co</td>
<td>324</td>
</tr>
<tr>
<td>Current assets</td>
<td>370</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,054</strong></td>
</tr>
<tr>
<td></td>
<td>Balestier Co</td>
</tr>
<tr>
<td>---------------------------</td>
<td>--------------</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>540 $'000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>414 $'000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>100 $'000</td>
</tr>
<tr>
<td></td>
<td>1,054 $'000</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>153 $'000</td>
</tr>
<tr>
<td>Tax</td>
<td>(45) $'000</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>108 $'000</td>
</tr>
</tbody>
</table>

No entries have been made in the accounts for any of the following transactions.

Assume that profits accrue evenly throughout the year.

It is the group's policy to measure the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Ignore taxation arising on disposals.

Required

Prepare the consolidated statement of financial position and statement of profit or loss at 30 September 20X8 in each of the following circumstances. (Assume no impairment of goodwill.)

(a) Balestier Co sells its entire holding in Woodlands Co for $650,000 on 30 September 20X8.

(b) Balestier Co sells one quarter of its holding in Woodlands Co for $160,000 on 30 June 20X8.

(c) Balestier Co sells one half of its holding in Woodlands Co for $340,000 on 30 June 20X8, and the remaining holding (fair value $250,000) is to be dealt with as an associate.

(d) Balestier Co sells one half of its holding in Woodlands Co for $340,000 on 30 June 20X8, and the remaining holding (fair value $250,000) is to be measured at fair value in accordance with SFRS(I) 9. Assume there is no change in fair value on 30 September 20X8.

2.9 Loss of control in a transaction involving an associate or joint venture

SFRS(I) 10 specifically addresses the situation in which;

(a) An investor loses control of a subsidiary that does not contain a business as defined in SFRS(I) 3 Business Combinations; and

(b) The transaction involves an associate or joint venture of the investor that is accounted for using the equity method.

An example of this situation is where a parent company sells all or part of its interest in a subsidiary (that does not contain a business), such that it lost control, to its associate.

In this situation:

(a) The gain or loss calculated is recognised by the investor only to the extent of the unrelated investors' interests in the associate or joint venture.

(b) The remaining part of the gain is eliminated against the carrying amount of the investment in the associate or joint venture.

Where the investor retains an interest in the former subsidiary such that it is now an associate or joint venture itself:

(a) The gain or loss on remeasurement of the retained investment is recognised in profit or loss only to the extent of the unrelated investors' interests in the new associate or joint venture.
(b) The remaining part of the gain or loss is eliminated against the carrying amount of the investment retained in the former subsidiary.

Where a retained interest is a financial asset accounted for in accordance with SFRS(I) 9, the full gain or loss associated with the remeasurement of the retained interest is recognised in profit or loss.

### Example

At 1 January 20X1, P Group has:

- A 100% interest in S Ltd; that company does not contain a business as defined in SFRS(I) 3.
- A 40% interest in A Ltd, which is classified as an associate.

On 1 April 20X4, P Ltd sells 80% of its interest in S Ltd to A Ltd for $15 million. On the date of the sale the carrying amount of the net assets of the subsidiary is $17.5 million.

The 20% interest retained in S Ltd is classified as an associate and has a fair value of $4 million at 1 April 20X4.

**Required**

Explain how the disposal is accounted for in the P Group consolidated financial statements for the year ended 31 December 20X4.

**Solution**

(i) A gain arises on the sale of the 80% interest:

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>15,000</td>
</tr>
<tr>
<td>Carrying amount of interest sold (80% × $17,5m)</td>
<td>(14,000)</td>
</tr>
<tr>
<td>Gain</td>
<td>1,000</td>
</tr>
</tbody>
</table>

60% of this gain (ie $600,000) is attributable to the unrelated investors in A Ltd and is recognised in profit or loss; the remaining $400,000 is eliminated against the carrying amount of A Ltd.

(ii) A gain also arises on the remeasurement of the retained interest:

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value</td>
<td>4,000</td>
</tr>
<tr>
<td>Carrying amount of interest retained (20% × $17.5m)</td>
<td>(3,500)</td>
</tr>
<tr>
<td>Gain</td>
<td>500</td>
</tr>
</tbody>
</table>

This gain is recognised in profit or loss only to the extent that it is attributable to the unrelated investors of the new associate. The unrelated investors are 60% of the shareholders in A Ltd; A Ltd holds 80% of S Ltd and therefore 60% × 80% = 48% unrelated shareholding.

Therefore 48% of the gain ($240,000) is recognised in profit or loss and the remaining $260,000 is eliminated against the carrying amount of S Ltd.

### 2.10 Disposal of shares in an associate

Shares in an associate investment may be disposed of such that the investing entity retains:

(a) No investment (ie a full disposal)
(b) A financial asset investment
(c) An associate investment
2.10.1 Full disposal

The gain or loss on the full disposal of an investment in an associate is calculated as:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration received</td>
<td>( X )</td>
</tr>
<tr>
<td>Carrying amount of associate at disposal date</td>
<td>( (X) )</td>
</tr>
<tr>
<td>Gain or loss</td>
<td>( \frac{X}{X} )</td>
</tr>
</tbody>
</table>

Note that the carrying amount of the investment (and therefore the gain or loss on disposal) may be different in the separate financial statements of the parent company and the consolidated financial statements; it is based on equity accounting principles in the consolidated financial statements, whereas it may be measured at cost, in accordance with SFRS(I) 9 or in accordance with equity accounting principles in the financial statements of the parent company.

The gain or loss that arises on disposal is recognised in profit or loss.

In addition, any amounts that have been recognised in other comprehensive income in relation to the associate are accounted for on the same basis as if the related assets of liabilities had been disposed of. Therefore some other comprehensive income may require reclassification to profit or loss on the disposal of the associate.

The results of the associate are equity accounted up to the date of disposal.

**Example**

Aramis Group acquired significant influence over Diego Co on 1 May 20X1 when it acquired 40% of that company's shares at a cost of $9 million. The shareholding is sold on 18 August 20X9 for $17.5 million. Between the acquisition date and the disposal date, Diego Co reported profits of $28 million and other comprehensive income of $10 million, comprising a net amount of $9 million in respect of the revaluation of property and a net amount of $1 million in respect of cash flow hedges. The company also paid dividends of $19 million. The investment has not suffered an impairment loss.

**Required**

Calculate the gain on the disposal of the shares in Diego Co that is recognised in the consolidated statement of profit or loss of the Aramis Group.

**Solution**

The gain is calculated as:

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration received</td>
<td>17,500</td>
</tr>
<tr>
<td>Cost of investment</td>
<td>9,000</td>
</tr>
<tr>
<td>Share of post-acquisition profits (40% \times ($28m - $19m))</td>
<td>3,600</td>
</tr>
<tr>
<td>Share of post-acquisition net OCI (40% \times $10m)</td>
<td>4,000</td>
</tr>
<tr>
<td><strong>Gain on disposal</strong></td>
<td><strong>900</strong></td>
</tr>
</tbody>
</table>

In addition the net amount of $400,000 \(40\% \times \$1m\) recognised as OCI in the consolidated financial statements in respect of Diego Co's cash flow hedges is reclassified to profit or loss on the disposal. The OCI in respect of the revaluation of property is not reclassified to profit or loss.
2.10.2 Part disposal – associate retained

Where part of an investment in an associate (or joint venture) is disposed of, such that an associate (or joint venture) investment is retained, the gain or loss calculation is as follows:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration received</td>
<td>X</td>
</tr>
<tr>
<td>Proportion of carrying amount disposed of</td>
<td>(X)</td>
</tr>
<tr>
<td>Gain or loss on disposal</td>
<td>X/(X)</td>
</tr>
</tbody>
</table>

Amounts previously recognised in other comprehensive income that relate to the reduction in ownership interest (i.e., the proportion related to the investment disposed of) are reclassified to profit or loss if they would be required to be reclassified on the disposal of the related assets and liabilities.

After disposal, the remaining shareholding is accounted for in accordance with the relevant accounting standard:

- [SFRS(I) 1-28 Investments in Associates and Joint Ventures](#) (and SFRS(I) 11 Joint Arrangements) (in the consolidated financial statements)
- [SFRS(I) 1-27 Separate Financial Statements](#) (in the separate financial statements).

**Example**

Assume the facts of the previous example, however:

- The shareholding is reduced to 30% and significant influence is retained
- Consideration amounts to $4,700

*Required*

Calculate the gain or loss on disposal.

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration received</td>
<td>4,700</td>
</tr>
<tr>
<td>Proportion of carrying amount disposed of (10/40 × $16,600)</td>
<td>(4,150)</td>
</tr>
<tr>
<td>Gain on disposal</td>
<td>550</td>
</tr>
</tbody>
</table>

In addition the net amount of $100,000 (40% × $1m × 10/40) recognised as OCI in the consolidated financial statements in respect of Diego Co’s cash flow hedges is reclassified to profit or loss on the disposal.

2.10.3 Part disposal – financial asset retained

Where part of an investment in an associate is disposed of, such that a financial asset investment is retained, the gain or loss calculation differs slightly in that the retained interest is remeasured to fair value and the remeasurement gain or loss forms part of the total gain or loss:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration received</td>
<td>X</td>
</tr>
<tr>
<td>Fair value of retained interest</td>
<td>X</td>
</tr>
<tr>
<td>Carrying amount of associate at disposal date</td>
<td>(X)</td>
</tr>
<tr>
<td>Gain or loss on disposal</td>
<td>X/(X)</td>
</tr>
</tbody>
</table>

Here equity accounting is discontinued and therefore amounts previously recognised in other comprehensive income in respect of the associate are all reclassified to profit or loss if they would be required to be reclassified on the disposal of the related assets and liabilities.

After disposal, any remaining shareholding is accounted for in accordance with SFRS(I) 9 Financial Instruments.
Example

Again assume the facts of the example in section 2.10.1, however:

- The shareholding is reduced to 10% and significant influence is lost
- Consideration amounts to $14,500
- The fair value of a 10% shareholding is $4,100

**Required**

Calculate the gain or loss on disposal.

**Solution**

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration received</td>
<td>14,500</td>
</tr>
<tr>
<td>Fair value of retained shareholding</td>
<td>4,100</td>
</tr>
<tr>
<td>Carrying amount of associate at disposal date</td>
<td>(16,600)</td>
</tr>
<tr>
<td>Gain on disposal</td>
<td>2,000</td>
</tr>
</tbody>
</table>

In addition the whole of the net amount of $400,000 (40% × $1m) recognised as OCI in the consolidated financial statements in respect of Diego Co's cash flow hedges is reclassified to profit or loss on the disposal.

**SECTION SUMMARY**

- The effective date of disposal is when **control passes**
- Disposals may be **full** or **partial**, to subsidiary, associate or investment status
  - **If control is lost**, any interest retained is **fair valued** and becomes part of the calculation of the gain or loss on disposal
  - **If control is retained**, the change in the non-controlling interest is shown as **an adjustment to the parent's equity**
- **Gain or loss** on disposal is calculated for the parent company and the group
Gain reported in accordance with SFRS(I) 9 if previously held interest was financial asset or profit or loss otherwise

Goodwill calculation based on acquirer’s previously held interest is recalculated

Gain reported in accordance with SFRS(I) 9 if previously held interest was profit or loss otherwise

Goodwill is not recalculated

Gain or loss on disposal is reported for Parent and Group unless control retained

Control is lost

Control is lost by fair value measurement

Gain or loss on disposal is reported for Parent and Group unless control retained

Increase in stake in subsidiary

Increase in stake in subsidiary

Full

Partial

Disposal

Step acquisition

Control achieved in stages

Chapter Roundup

Changes in group structure
Quick Quiz

1. Control is always lost when there is a disposal. True or false?
2. Why is the fair value of the interest retained used in the calculation of a gain on disposal where control is lost?
3. When is the effective date of disposal of shares in an investment?
4. Subside owns 60% of Diary at 31 December 20X8. On 1 July 20X9, it buys a further 20% of Diary. How should this transaction be treated in the group financial statements at 31 December 20X9?
5. Ditch had a 75% subsidiary, Dodge, at 30 June 20X8. On 1 January 20X9, it sold two-thirds of this investment, leaving it with a 25% holding, over which it retained significant influence. How will the remaining investment in Dodge appear in the group statement of financial position 30 June 20X9?
Answers to Quick Quiz

1 False. Control may be retained if the disposal is from subsidiary to subsidiary, even though the parent owns less and the non-controlling interest owns more.

2 It may be viewed as part of the consideration received.

3 When control passes

4 As a transaction between owners, with an adjustment to the parent's equity to reflect the difference between the consideration paid and the decrease in non-controlling interest.

5 At its fair value at the date of disposal plus a 25% share of the profits accrued between the date of disposal and the year-end, less any impairment at the year-end.

Answers to Questions

28.1 Step acquisition

(a) Goodwill (at date control obtained)

<table>
<thead>
<tr>
<th></th>
<th>$m</th>
<th>$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>480</td>
<td></td>
</tr>
<tr>
<td>NCI (20% × 750*)</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Fair value of previously held equity interest</td>
<td>160</td>
<td></td>
</tr>
<tr>
<td>Fair value of identifiable assets acquired and liabilities assumed</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>450</td>
<td></td>
</tr>
<tr>
<td>(750)</td>
<td></td>
<td>40</td>
</tr>
</tbody>
</table>

* Retained earnings $450m + Equity $300m

(b) Gain on derecognition of investment

<table>
<thead>
<tr>
<th></th>
<th>$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of previously held equity interest at date control obtained</td>
<td>160</td>
</tr>
<tr>
<td>Carrying amount of previously held equity interest at date control obtained</td>
<td>(120)</td>
</tr>
</tbody>
</table>

28.2 Disposal

(a) Complete disposal at year-end (80% to 0%)

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X8

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td>360</td>
</tr>
<tr>
<td>Current assets (370 + 650)</td>
<td>1,020</td>
</tr>
<tr>
<td></td>
<td>1,380</td>
</tr>
</tbody>
</table>

Equity

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary share capital</td>
<td>540</td>
</tr>
<tr>
<td>Retained earnings (W3)</td>
<td>740</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>1,380</td>
</tr>
</tbody>
</table>
CONSOLIDATED STATEMENT OF PROFIT OR LOSS
FOR THE YEAR ENDED 30 SEPTEMBER 20X8

$000

Profit before tax (153 + 126) 279
Profit on disposal (W2) 182
Tax (45 + 36) (81)

Profit attributable to:
Owners of the parent (108 + 182 + (80% \times 90)) 362
Non-controlling interest (20% \times 90) 18

380

Workings
1  
Timeline

1.10.X7 30.9.X8

P/L Subsidiary – all year

Group gain on disposal not sub at y/e

2  Profit on disposal of Woodlands Co

$'000 $'000

Fair value of consideration received 650
Less share of consolidated carrying amount when control lost:
  net assets ($180k + $360k) 540
  goodwill (see below) 36
  non-controlling interest: 20% \times 540 (108)

(468)

182

Working for goodwill

$'000

Consideration transferred 324
NCI (20% \times 360) 72
Acquired: (180 + 180) (360) 36

3 Retained earnings carried forward

Balestier Woodlands

$'000 $'000

Per question/date of disposal 414 360
Add group gain on disposal (W2) 182 –
Reserves at acquisition – (180) 180
Share of post-acq’n reserves up to the disposal (80% \times 180) 144 740

807
(b) **Partial disposal: subsidiary to subsidiary (80% to 60%)**

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X8**

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td>630</td>
</tr>
<tr>
<td>Goodwill (part (a))</td>
<td>36</td>
</tr>
<tr>
<td>Current assets</td>
<td>900</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,566</td>
</tr>
</tbody>
</table>

**Equity**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary share capital</td>
<td>540</td>
</tr>
<tr>
<td>Retained earnings (W3)</td>
<td>610</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,150</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-controlling interest (W4)</td>
<td>216</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>200</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,566</td>
</tr>
</tbody>
</table>

**CONSOLIDATED STATEMENT OF PROFIT OR LOSS**

**FOR THE YEAR ENDED 30 SEPTEMBER 20X8**

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax</td>
<td>279</td>
<td></td>
</tr>
<tr>
<td>Tax</td>
<td>(81)</td>
<td></td>
</tr>
<tr>
<td>Profit for the period</td>
<td>198</td>
<td></td>
</tr>
</tbody>
</table>

**Profit attributable to:**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Owners of the parent</td>
<td>175.5</td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>22.5</td>
</tr>
</tbody>
</table>

**Workings**

1. **Timeline**

```
1.10.X7        30.6.X8  30.9.X8
   P/L
   Subsidiary–all year
   20% NCI × 9/12
   Retained control (60%) – so adjust parent's equity
   Sells 36,000 shares
   Consol – 40% NCI
```

2. **Adjustment to parent's equity on disposal of 20% of Woodlands**

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of consideration received</td>
<td>160.0</td>
</tr>
<tr>
<td>Less increase in NCI in net assets at disposal 20% × (540 – (3/12 × 90))</td>
<td>(103.5)</td>
</tr>
</tbody>
</table>
3  Group retained earnings

<table>
<thead>
<tr>
<th></th>
<th>Balestier $’000</th>
<th>Woodlands 80% $’000</th>
<th>Woodlands 60% retained $’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per question/at date of disposal (360 – (90 × 3/12))</td>
<td>414.0</td>
<td>337.5</td>
<td>360.0</td>
</tr>
<tr>
<td>Adjustment to parent’s equity on disposal (W2)</td>
<td>56.5</td>
<td>(180.0)</td>
<td>(337.5)</td>
</tr>
<tr>
<td>Retained earnings at acquisition</td>
<td></td>
<td>157.5</td>
<td>22.5</td>
</tr>
</tbody>
</table>

Woodlands: share of post acq’n. earnings (157.5 × 80%) 126.0
Woodlands: share of post acq’n. earnings (22.5 × 60%) 13.5

610.0

4  Non-controlling interests (SOFP)

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>NCI at acquisition (part (a) – goodwill)</td>
<td>72.0</td>
<td></td>
</tr>
<tr>
<td>NCI share of post acq’n reserves (W3) (157.5 × 20%)</td>
<td>31.5</td>
<td>103.5</td>
</tr>
<tr>
<td>(22.5 × 40%)</td>
<td>9.0</td>
<td></td>
</tr>
<tr>
<td>Increase in NCI (W2)</td>
<td>103.5</td>
<td>216.0</td>
</tr>
</tbody>
</table>

(c) Partial disposal: subsidiary to associate (80% to 40%)

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X8

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td>360</td>
</tr>
<tr>
<td>Investment in associate (W4)</td>
<td>259</td>
</tr>
<tr>
<td>Current assets (370 + 340)</td>
<td>710</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,329</strong></td>
</tr>
</tbody>
</table>

**Equity**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary share capital</td>
<td>540</td>
</tr>
<tr>
<td>Retained earnings (W3)</td>
<td>689</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>100</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,329</strong></td>
</tr>
</tbody>
</table>

CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 SEPTEMBER 20X8

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax (153 + 9/12 × 126)</td>
<td>247.5</td>
</tr>
<tr>
<td>Profit on disposal (W2)</td>
<td>140.0</td>
</tr>
<tr>
<td>Share of profit of associate (90 × 3/12 × 40%)</td>
<td>9.0</td>
</tr>
<tr>
<td>Tax (45 + (9/12 × 36))</td>
<td>(72.0)</td>
</tr>
<tr>
<td>Profit for the period</td>
<td><strong>324.5</strong></td>
</tr>
<tr>
<td>Profit attributable to:</td>
<td></td>
</tr>
<tr>
<td>Owners of the parent (108 + 140 + (80% × 90 × 9/12) + (40% × 90 × 3/12))</td>
<td>311.0</td>
</tr>
<tr>
<td>Non-controlling interest (20% × 90 × 9/12)</td>
<td>13.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>324.5</strong></td>
</tr>
</tbody>
</table>
Workings

1  **Timeline**

1.10.X7  30.6.X8  30.9.X8

P/L

Subsidiary (80% – 9/12)  
Associate – 3/12

Sells = 40% of Woodlands  
Equity account in SOFP

Group gain on disposal

2  **Profit on disposal**

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of consideration received</td>
<td></td>
<td>340</td>
</tr>
<tr>
<td>Fair value of 40% investment retained</td>
<td></td>
<td>250</td>
</tr>
<tr>
<td>Less share of consolidated carrying amount when control lost</td>
<td></td>
<td>517.5</td>
</tr>
<tr>
<td>540 – (90 × 3/12)</td>
<td></td>
<td>517.5</td>
</tr>
<tr>
<td>Goodwill (part (a))</td>
<td></td>
<td>36.0</td>
</tr>
<tr>
<td>Less NCI 20% × ((540 – (90 × 3/12))</td>
<td></td>
<td>(103.5)</td>
</tr>
<tr>
<td>(450)</td>
<td></td>
<td>140</td>
</tr>
</tbody>
</table>

3  **Group retained earnings**

<table>
<thead>
<tr>
<th></th>
<th>Balestier</th>
<th>Woodlands 80% (sub)</th>
<th>Woodlands 40% retained (assoc.)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$’000</td>
<td>$’000</td>
<td>$’000</td>
</tr>
<tr>
<td>Per question/at date of disposal</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(360 – (90 × 3/12))/at reporting date</td>
<td>414</td>
<td>337.5</td>
<td>360.0</td>
</tr>
<tr>
<td>Group profit on disposal (W2)</td>
<td>140</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings at acquisition/date control lost</td>
<td></td>
<td>(180.0)</td>
<td>(337.5)</td>
</tr>
<tr>
<td>Woodlands: share of post acqn. earnings</td>
<td></td>
<td>157.5</td>
<td>22.5</td>
</tr>
<tr>
<td>(157.5 × 80%)</td>
<td></td>
<td>126</td>
<td></td>
</tr>
<tr>
<td>Woodlands: share of post acqn. earnings</td>
<td></td>
<td>9</td>
<td>689</td>
</tr>
<tr>
<td>(22.5 × 40%)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

4  **Investment in associate**

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value at date control lost (new ‘cost’)</td>
<td>250</td>
</tr>
<tr>
<td>Share of post ‘acq’n retained reserves (90 × 3/12 × 40%) (or from W3)</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>259</td>
</tr>
</tbody>
</table>
(d) Partial disposal: subsidiary to financial asset (80% to 40%)

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X8

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td>360</td>
</tr>
<tr>
<td>Investment</td>
<td>250</td>
</tr>
<tr>
<td>Current assets (370 + 340)</td>
<td>710</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>540</td>
</tr>
<tr>
<td>Retained earnings (W2)</td>
<td>680</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>100</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,320</td>
</tr>
</tbody>
</table>

CONSOLIDATED STATEMENT OF PROFIT OR LOSS
FOR THE YEAR ENDED 30 SEPTEMBER 20X8

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax (153 + (9/12 x 126))</td>
<td>247.5</td>
</tr>
<tr>
<td>Profit on disposal (See (c) above)</td>
<td>140.0</td>
</tr>
<tr>
<td>Tax (45 + (9/12 x 36))</td>
<td>(72.0)</td>
</tr>
<tr>
<td>Profit for the period</td>
<td>315.5</td>
</tr>
<tr>
<td>Profit attributable to:</td>
<td></td>
</tr>
<tr>
<td>Owners of the parent (108 + 140 + (80% x 90 x 9/12))</td>
<td>302.0</td>
</tr>
<tr>
<td>Non-controlling interest (20% x 90 x 9/12)</td>
<td>13.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>315.5</td>
</tr>
</tbody>
</table>

Workings

1. **Timeline**

   - 1.10.X7
   - 30.6.X8
   - 30.9.X8

2. **Retained earnings**

<table>
<thead>
<tr>
<th></th>
<th>Balestier $'000</th>
<th>Woodlands $'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per question/at date of disposal (360 – (90 x 3/12))</td>
<td>414</td>
<td>337.5</td>
</tr>
<tr>
<td>Group profit on disposal (see (c) above)</td>
<td>140</td>
<td></td>
</tr>
<tr>
<td>Retained earnings at acquisition</td>
<td>(180.0)</td>
<td>157.5</td>
</tr>
<tr>
<td>Woodlands: share of post acq'n. earnings (157.5 x 80%)</td>
<td>126</td>
<td>680</td>
</tr>
</tbody>
</table>
Many of the largest companies in any country, while based there, have subsidiaries and other interests all over the world: they are truly global companies and so foreign currency consolidations take place frequently in practice.
1 Translation of financial statements

SECTION INTRODUCTION

The financial statements of a foreign subsidiary need to be translated into the group presentation currency before they are consolidated.

SFRS(I) 1-21 *The Effects of Changes in Foreign Exchange Rates* was introduced in Chapter 6. There we discussed how foreign currency transactions entered into by a company reporting in Singapore $ are dealt with.

In this chapter, we consider how to consolidate a subsidiary (or branch) which reports its financial statements in a currency which is different from the group reporting currency.

Note: This chapter primarily deals with the treatment of subsidiaries but SFRS(I) 1-21 also covers joint arrangements, associates and branches.

First we shall revisit some SFRS(I) 1-21 definitions which we considered in Chapter 6.
1.1 Definitions

These are some of the definitions given by SFRS(I) 1-21.

**KEY TERMS**

**FOREIGN CURRENCY** A currency other than the functional currency of the entity.

**FUNCTIONAL CURRENCY** The currency of the primary economic environment in which the entity operates.

**PRESENTATION CURRENCY** The currency in which the financial statements are presented.

**EXCHANGE RATE** The ratio of exchange for two currencies.

**EXCHANGE DIFFERENCE** The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

**CLOSING RATE** The spot exchange rate at the end of the reporting period.

**SPOT EXCHANGE RATE** The exchange rate for immediate delivery.

**MONETARY ITEMS** Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. (SFRS(I) 1-21)

1.2 Determining functional currency

As we saw in Chapter 6, SFRS(I) 1-21 states that an entity should consider the following factors in determining its functional currency:

(a) The currency that mainly influences sales prices for goods and services (often the currency in which prices are denominated and settled)

(b) The currency of the country whose competitive forces and regulations mainly determine the sale price of its goods and services

(c) The currency that mainly influences labour, material and other costs of providing goods or services (often the currency in which prices are denominated and settled)

Sometimes the functional currency of an entity is not immediately obvious. Management must then exercise judgment and may also need to consider:

(a) The currency in which funds from financing activities (raising loans and issuing equity) are generated

(b) The currency in which receipts from operating activities are usually retained

In addition, where an entity is a foreign subsidiary, a number of further factors are considered:

(a) Whether the activities of the foreign operation are carried out as an extension of the parent, rather than being carried out with a significant degree of autonomy

(b) Whether transactions with the parent are a high or a low proportion of the foreign operation’s activities

(c) Whether cash flows from the activities of the foreign operation directly affect the cash flows of the parent and are readily available for remittance to it

(d) Whether the activities of the foreign operation are financed from its own cash flows or by borrowing from the parent
### Example

The following extract is taken from the Annual Report 2017 of Vietnam Infrastructure Limited:

FAR EAST ORCHARD LIMITED

NOTES TO THE FINANCIAL STATEMENTS

2  SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

2.22  Currency translation

(a)  Functional and presentation currency

Items included in the financial statements of each entity in the Group are measured using the currency of the primary economic environment in which the entity operates (“functional currency”). The financial statements are presented in Singapore Dollars, which is the functional currency of the Company.

(Extracted from the annual report available at http://www.fareastorchard.com.sg/annual-reports/2017/web/resources/Far_East_Orchard_AR__.pdf)

### 1.2.1 Change in functional currency

The functional currency of an entity can be changed only if there is a change to the underlying transactions, events and conditions that are relevant to the entity. For example, an entity's functional currency may change if there is a change in the currency that mainly influences the sale price of goods and services.

Where there is a change in an entity's functional currency, the entity translates all items into the new functional currency *prospectively* (ie, from the date of the change) using the exchange rate at the date of the change.

### 1.3 Translation to the presentation currency

Where the functional currency of the foreign operation differs from the presentation currency of the group its results will be translated into the presentation currency. The procedures for translation are as follows:

<table>
<thead>
<tr>
<th>Assets and liabilities</th>
<th>Amounts in the statement of profit or loss and other comprehensive income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closing rate at period end</td>
<td>Average rate for the year (as approximation for spot rate at date of each transaction)</td>
</tr>
</tbody>
</table>

Exchange differences in other comprehensive income

Practically speaking, when translating the statement of financial position for consolidation purposes, a subsidiary’s share capital is translated at the **historical rate** (the rate when the investing company acquired its interest or when capital is injected into the subsidiary).
1.3.1 Change in presentation currency

SFRS(I) 1-21 does not address this issue but is not an uncommon occurrence. The presentation currency of an entity can be changed but this would generally be considered similar to an accounting policy change. This would therefore require the translation of the comparatives in the same way as the statements of the year in question were translated. The translation should be performed as if the new presentation currency had always been the presentation currency ie retrospective treatment is required.

1.4 Analysis of exchange differences

The exchange differences on translation of financial statements from functional to presentation currency arise in respect of two issues:

- Income/expense items are translated at the exchange rates at the date of transactions, whereas the assets/liabilities to which they relate are translated at the closing rate.
- Opening net assets in the foreign entity are translated at a closing rate different from the closing rate at which they were previously reported.

The exchange difference can therefore be calculated as:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening net assets at closing rate</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Opening net assets at opening rate</td>
<td>X</td>
<td>X/(X)</td>
</tr>
<tr>
<td>Exchange gain/(loss)</td>
<td></td>
<td>X/(X)</td>
</tr>
<tr>
<td>Retained profits during the period at closing rate</td>
<td>X</td>
<td>X/(X)</td>
</tr>
<tr>
<td>Retained profits during the period at average rate</td>
<td>X</td>
<td>X/(X)</td>
</tr>
<tr>
<td>Exchange gain/(loss)</td>
<td></td>
<td>X/(X)</td>
</tr>
<tr>
<td>Overall exchange gain/(loss)</td>
<td></td>
<td>X/(X)</td>
</tr>
</tbody>
</table>

The exchange difference is recognised in other comprehensive income and accumulated in a separate component of equity. This is normally known as Foreign Exchange Reserves or Foreign Currency Translation Reserves (‘FCTR’).

Where there is a non-controlling interest in a subsidiary, a proportion of the exchange difference is allocated to the NCI.

Example

L Ltd, a Singapore company, has an investment in a European company, B SA. B's functional currency is the euro and its abbreviated statement of financial position as at 31 December 20X1 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>31 Dec 20X0</th>
<th>31 Dec 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td>780,000</td>
<td>780,000</td>
</tr>
<tr>
<td>Current assets</td>
<td>412,000</td>
<td>490,000</td>
</tr>
<tr>
<td></td>
<td>1,192,000</td>
<td>1,270,000</td>
</tr>
<tr>
<td>Share capital</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>612,000</td>
<td>690,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>480,000</td>
<td>480,000</td>
</tr>
<tr>
<td></td>
<td>1,192,000</td>
<td>1,270,000</td>
</tr>
</tbody>
</table>

B made retained profits of €78,000 for the year.

Retained earnings as at 31 December 20X0 in Singapore $ is $844,138.

Prepare the statement of financial position of B in Singapore $, including a foreign exchange reserve.

Exchange rates

<table>
<thead>
<tr>
<th></th>
<th>31 December 20X1</th>
<th></th>
<th>31 December 20X0</th>
<th></th>
<th>Average for year</th>
<th></th>
<th>At acquisition</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$1: €0.6</td>
<td></td>
<td>$1: €0.75</td>
<td></td>
<td>$1: €0.7</td>
<td></td>
<td>$1: €0.65</td>
<td></td>
</tr>
</tbody>
</table>
Solution

STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X0

<table>
<thead>
<tr>
<th></th>
<th>€</th>
<th>SGD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td>780,000</td>
<td>1,040,000</td>
</tr>
<tr>
<td>Current assets</td>
<td>412,000</td>
<td>549,333</td>
</tr>
<tr>
<td></td>
<td>1,192,000</td>
<td>1,589,333</td>
</tr>
<tr>
<td>Share capital</td>
<td>100,000</td>
<td>153,846</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>612,000</td>
<td>844,138</td>
</tr>
<tr>
<td>Foreign Exchange Reserves W1</td>
<td>712,000</td>
<td>(48,651)</td>
</tr>
<tr>
<td></td>
<td>1,192,000</td>
<td>1,589,333</td>
</tr>
<tr>
<td>Liabilities</td>
<td>480,000</td>
<td>640,000</td>
</tr>
</tbody>
</table>

AS AT 31 DECEMBER 20X1

<table>
<thead>
<tr>
<th></th>
<th>€</th>
<th>SGD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td>780,000</td>
<td>1,300,000</td>
</tr>
<tr>
<td>Current assets</td>
<td>490,000</td>
<td>816,667</td>
</tr>
<tr>
<td></td>
<td>1,270,000</td>
<td>2,116,667</td>
</tr>
<tr>
<td>Share capital</td>
<td>100,000</td>
<td>153,846</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>690,000</td>
<td>955,567</td>
</tr>
<tr>
<td>Foreign Exchange Reserves W2</td>
<td>790,000</td>
<td>207,254</td>
</tr>
<tr>
<td></td>
<td>1,270,000</td>
<td>2,116,667</td>
</tr>
<tr>
<td>Liabilities</td>
<td>480,000</td>
<td>800,000</td>
</tr>
</tbody>
</table>

Workings

1. Foreign Exchange Reserves arose from the difference in exchange rate carried in the Singapore dollar against the closing rate at 31 December 20X0.

<table>
<thead>
<tr>
<th></th>
<th>€</th>
<th>SGD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital at historical rate</td>
<td>100,000</td>
<td>153,846</td>
</tr>
<tr>
<td>Share capital at closing rate</td>
<td>100,000</td>
<td>133,333</td>
</tr>
<tr>
<td><strong>Difference from Share Capital</strong></td>
<td></td>
<td><strong>(20,513)</strong></td>
</tr>
<tr>
<td>Retained Earnings accumulated from past translation of past profit and loss statements</td>
<td>612,000</td>
<td>844,138</td>
</tr>
<tr>
<td>Retained Earnings at closing rate</td>
<td>612,000</td>
<td>816,000</td>
</tr>
<tr>
<td><strong>Difference from Retained Earnings</strong></td>
<td></td>
<td><strong>(28,138)</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>(48,651)</strong></td>
</tr>
</tbody>
</table>
2. Retained earnings is an accumulated figure from the translation of past income statement at the rate ruling at the date of transaction or average rate.

<table>
<thead>
<tr>
<th></th>
<th>20X0</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>612,000</td>
<td>844,138</td>
</tr>
<tr>
<td>Current year retained</td>
<td>78,000</td>
<td>111,429</td>
</tr>
<tr>
<td>Retained earnings at</td>
<td></td>
<td>955,567</td>
</tr>
</tbody>
</table>

3. Exchange gains and losses on disposal

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening net assets at closing rate (790 – 78)/0.6</td>
<td>$1,186,667</td>
</tr>
<tr>
<td>Opening net assets at opening rate (790 – 78)/0.75</td>
<td>$949,333</td>
</tr>
<tr>
<td>Exchange gain</td>
<td>$237,334</td>
</tr>
<tr>
<td>Retained profits during the year at closing rate (78/0.6)</td>
<td>$130,000</td>
</tr>
<tr>
<td>Retained profits during the year at average rate (78/0.7)</td>
<td>$111,429</td>
</tr>
<tr>
<td>Exchange gain/(loss)</td>
<td>$18,571</td>
</tr>
<tr>
<td>Overall exchange gain</td>
<td>$255,905</td>
</tr>
</tbody>
</table>

Foreign exchange reserves

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign exchange reserves at 31 Dec 20X0</td>
<td>(48,651)</td>
</tr>
<tr>
<td>Movements during the year</td>
<td>$255,905</td>
</tr>
<tr>
<td>Foreign exchange reserves at 31 Dec 20X1</td>
<td>$207,254</td>
</tr>
</tbody>
</table>

1.4.1 Exchange gains and losses on disposal

When a parent disposes of a foreign entity, the cumulative amount of exchange differences relating to that foreign entity should be reclassified to profit or loss and recognised as income or an expense in the same period in which the gain or loss on disposal is recognised. Effectively, this means that these exchange differences are recognised once by taking them to reserves and then are recognised for a second time by transferring them to profit or loss on disposal of the foreign operation.

When there is a change in ownership interests that does not lead to a change in control of a subsidiary the foreign exchange gain or loss shall be reclassified to non-controlling interests.

SECTION SUMMARY

SFRS(I) 1-21 requires that the financial statements of a foreign subsidiary are translated as follows:

- Assets and liabilities at the closing rate
- Income and expenses at the transaction date rate (approximated to average rate)

Exchange gains and losses arising are reported in other comprehensive income and accumulated in a separate component of equity.
2 Consolidation

SECTION INTRODUCTION

The basic consolidation procedures for consolidating a foreign operation are the same as those we have already seen.

Once the financial statements of a foreign operation have been translated into the presentation currency of the parent, they must be consolidated. The approach to the consolidation is essentially the same as that which we have already seen.

Certain parts of the consolidation require further consideration and these are covered after the following question.

Question 29.1 Consolidated financial statements

The abridged statements of financial position and statements of profit or loss and other comprehensive income of Z Co and its foreign subsidiary, X Inc, appear below.

DRAFT STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

<table>
<thead>
<tr>
<th></th>
<th>Z Co $</th>
<th>X Inc €</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plant at cost</td>
<td>600</td>
<td>500</td>
</tr>
<tr>
<td>Less depreciation</td>
<td>(250)</td>
<td>(200)</td>
</tr>
<tr>
<td>Investment in X</td>
<td>350</td>
<td>300</td>
</tr>
<tr>
<td>100 €1 shares</td>
<td>25</td>
<td>–</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td>375</td>
<td>300</td>
</tr>
<tr>
<td>Inventories</td>
<td>225</td>
<td>200</td>
</tr>
<tr>
<td>Receivables</td>
<td>150</td>
<td>100</td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>375</td>
<td>300</td>
</tr>
<tr>
<td>Ordinary share capital (€1 per share in X Inc)</td>
<td>300</td>
<td>100</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>300</td>
<td>280</td>
</tr>
<tr>
<td><strong>Long-term loans</strong></td>
<td>600</td>
<td>380</td>
</tr>
<tr>
<td><strong>Current liabilities</strong></td>
<td>50</td>
<td>110</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>750</td>
<td>600</td>
</tr>
</tbody>
</table>

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9

<table>
<thead>
<tr>
<th></th>
<th>Z Co $</th>
<th>X Inc €</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax</td>
<td>200</td>
<td>160</td>
</tr>
<tr>
<td>Tax</td>
<td>100</td>
<td>80</td>
</tr>
<tr>
<td><strong>Profit after tax, retained</strong></td>
<td>100</td>
<td>80</td>
</tr>
</tbody>
</table>
The following further information is given.

(a) Z Co has had its interest in X Inc since the incorporation of the company. Neither company paid dividends during the year to 31 December 20X9 and neither company had any other comprehensive income in their separate financial statements.

(b) Depreciation is 8% per annum on cost.

(c) There have been no loan repayments or movements in non-current assets during the year. The opening inventory of X Inc was €120. Assume that inventory turnover times are very short.

(d) Exchange rates:
- € 4 to $1 when X Inc was incorporated
- €2.5 to $1 when X Inc acquired its non-current assets
- €2 to $1 on 31 December 20X8
- €1.6 to $1 average rate of exchange year ending 31 December 20X9
- €1 to $1 on 31 December 20X9.

Required

Prepare the summarised consolidated financial statements of Z Co.

Exchange differences on translation of foreign operations have been decided to be accumulated in retained earnings.

2.1 Goodwill and fair value adjustments

Goodwill and fair value adjustments arising on the acquisition of a foreign operation should be treated as assets and liabilities of the acquired entity. This means that they should be expressed in the functional currency of the foreign operation and translated at the closing rate.

The exchange gain or loss arising is recognised as other comprehensive income and accumulated in group equity.

Here is a layout for calculating goodwill and the exchange gain or loss. The parent holds 90% of the shares in a company reporting in francs. NCI is valued as the proportionate share of the fair value of the subsidiary's identifiable net assets.

<table>
<thead>
<tr>
<th>Goodwill</th>
<th>F’000</th>
<th>Rate</th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>72,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>6,600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>66,000 × 10%</td>
<td>78,600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>40,000</td>
<td>6*</td>
<td>2,100</td>
</tr>
<tr>
<td>Pre-acquisition retained earnings</td>
<td>26,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(66,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At 1.4.X1</td>
<td>12,600</td>
<td>6*</td>
<td>2,100</td>
</tr>
<tr>
<td>Foreign exchange gain</td>
<td>0</td>
<td>Balance</td>
<td>420</td>
</tr>
<tr>
<td>At 31.3.X7</td>
<td>12,600</td>
<td>6**</td>
<td>2,520</td>
</tr>
</tbody>
</table>

* Historic rate
** Closing rate

2.2 Intragroup balances and exchange differences

Intragroup transactions between parent and foreign subsidiary can lead to exchange gains and losses in the individual books and records of each entity. These exchange gains and losses are recognised in the profit or loss of each entity in accordance with the normal rules in transactions in foreign currencies.
On consolidation any exchange gains and losses in the individual profit or loss of the parent and subsidiary which do not eliminate are reported in the consolidated profit or loss.

There is one exception to this rule: where exchange differences arise on a long term intragroup loan from parent to subsidiary that is not planned or likely to be repaid in the foreseeable future.

In this case, the balance is regarded as part of the parent's investment in the foreign subsidiary. Therefore, the exchange gain or loss arising on the translation of this balance, which was recognised in the profit or loss in the parent's separate financial statements, is recognised in other comprehensive income in the consolidated financial statements. As a result the exchange difference is matched to (or hedged against) the exchange difference arising on translation of the foreign subsidiary's financial statements. As described previously, this exchange difference is recognised in the subsidiary's other comprehensive income.

In order to achieve this, a consolidation adjustment is required to transfer the gain or loss from the parent's own profit or loss where it was initially recognised to other comprehensive income in the consolidated accounts.

This type of hedge is referred to as a hedge of a net investment in a foreign operation by SFRS(I) 9.

**Example**

On 1 January 20X4 P Ltd made a loan to its subsidiary S Ltd in the subsidiary's functional currency, the Zot (ZT). Group presentation currency and the functional currency of P Ltd is the dollar ($). The loan amounted to ZT 1,000,000 and P Ltd has no plans to demand repayment in the near future. Exchange rates are as follows:

1 January 20X4 ZT: $1
31 December 20X4 ZT: $1.2

**Required**

Explain how the loan is accounted for in both P Ltd and S Ltd’s financial statements and the journals required to eliminate the intragroup amount on consolidation.

**Solution**

**P Ltd's financial statements**

On 1 January 20X0 the loan is translated at the spot rate and recognised by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan receivable (ZT1m/2) 500,000</td>
<td>Cash 500,000</td>
</tr>
</tbody>
</table>

At 31 December 20X0 the loan is retranslated using the closing rate to ZT1m/2.2 = $454,545. An exchange loss is recognised by ($):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange loss (profit or loss) 45,455</td>
<td>Loan receivable 45,455</td>
</tr>
</tbody>
</table>

**S Ltd's financial statements**

On 1 January 20X0 the loan is recognised by (ZT):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 1,000,000</td>
<td>Loan payable 1,000,000</td>
</tr>
</tbody>
</table>

At 31 December 20X0, the financial statements of S Ltd are translated into the group presentation currency. As part of this process the loan is translated to $1m/2.2 = $454,545. The total exchange difference on the translation of the statement of financial position from opening rate to closing rate (and the translation of the statement of profit or loss and other comprehensive income) is recognised in S Ltd’s OCI in accordance with SFRS(I) 1-21. This includes ZT 1m/2 – ZT 1m/2.2 = $45,455 exchange gain on the retranslation of the loan.
Consolidation

On consolidation the intragroup loan is eliminated by ($):

**DEBIT**  Loan payable (S Ltd)  
**CREDIT**  Loan receivable (P Ltd)  

The exchange difference on the loan in P Ltd's financial statements must be transferred to other comprehensive income in order to cancel against the exchange difference on translation of the financial statements of S Ltd. This is because the loan from P Ltd to S Ltd is part of P Ltd's investment in the subsidiary.

Therefore a second consolidation adjustment is required ($):

**DEBIT**  Other comprehensive income  
**CREDIT**  Profit or loss  

To net P Ltd's exchange loss on the intragroup loan with the exchange difference arising on the translation of S Ltd's financial statements.

2.3 Non-controlling interests

Remember that the non-controlling interest in other comprehensive income will:

- Include their share of exchange differences on translating the subsidiary
- Exclude exchange differences arising on retranslating goodwill if the group measures non-controlling interests at acquisition using the proportionate method.

Example

T acquired 70% of S a foreign company for Units 4,500 on 31 December 20X4 when the retained reserves of S were Units 1,125. No impairment losses had been necessary up to 31 December 20X7. Neither company paid or declared dividends during the year.

Group policy is to measure non-controlling interests at acquisition at their proportionate share of the fair value of the identifiable net assets.

<table>
<thead>
<tr>
<th>Exchange rates</th>
<th>Units to $1</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 December 20X4</td>
<td>4.5</td>
</tr>
<tr>
<td>31 December 20X6</td>
<td>4.3</td>
</tr>
<tr>
<td>31 December 20X7</td>
<td>4</td>
</tr>
<tr>
<td>Average exchange rate</td>
<td>3.8</td>
</tr>
</tbody>
</table>

Required

Prepare the consolidated statement of profit or loss and other comprehensive income, statement of financial position and statement of changes in equity (attributable to equity holders of the parent only) for the T Group for the year ended 31 December 20X7.

Note: In the exam you would expect the question to show the separate financial statements of the parent and the subsidiary. These have been included alongside the solution below, to make it easier to illustrate the methods being used.
Solution

Statement of financial position

In questions asking for a full set of financial statements including a foreign subsidiary, it is always best to start with the statement of financial position. The starting point, as always, is to draw up the group structure:

Group structure

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>T</td>
<td>31.12.X4</td>
<td>70%</td>
<td></td>
</tr>
<tr>
<td>S</td>
<td>Pre-acquisition retained reserves 1,125 units</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The following table includes:

- The separate statements of financial position of T and S, each in their own currency (these would normally be given within the question information)
- A column showing the exchange rates chosen to translate S's balances into $
- A column showing the translated statement of financial position of S
- A final column showing the consolidated statement of financial position for the T Group (consolidation workings are shown below the table)

STATEMENTS OF FINANCIAL POSITION AT 31 DECEMBER 20X7

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>Units</th>
<th>Rate</th>
<th>$</th>
<th>Consol</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>4,500</td>
<td>4,000</td>
<td>4</td>
<td>1,000</td>
<td>5,500</td>
</tr>
<tr>
<td>Goodwill (W1)</td>
<td></td>
<td></td>
<td></td>
<td>534</td>
<td></td>
</tr>
<tr>
<td>Investment in S</td>
<td>1,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>2,400</td>
<td>3,000</td>
<td>4</td>
<td>750</td>
<td>3,150</td>
</tr>
<tr>
<td></td>
<td>7,900</td>
<td>7,000</td>
<td></td>
<td>1,750</td>
<td>9,184</td>
</tr>
<tr>
<td>Share capital</td>
<td>2,000</td>
<td>2,250</td>
<td>4.5</td>
<td>500</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>7,900</td>
<td>7,000</td>
<td></td>
<td>1,750</td>
<td>9,184</td>
</tr>
<tr>
<td>Pre-acquisition reserves</td>
<td>2,000</td>
<td>1,125</td>
<td>4.5</td>
<td>250</td>
<td>750</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Post-acquisition reserves (W2)</td>
<td>4,400</td>
<td>2,825</td>
<td>β</td>
<td>800</td>
<td>5,019</td>
</tr>
<tr>
<td></td>
<td>6,400</td>
<td>6,200</td>
<td></td>
<td>1,550</td>
<td>7,019</td>
</tr>
<tr>
<td>Non-controlling interest (W3)</td>
<td></td>
<td></td>
<td></td>
<td>465</td>
<td>7,484</td>
</tr>
<tr>
<td>Loans</td>
<td>1,500</td>
<td>800</td>
<td>4</td>
<td>200</td>
<td>1,700</td>
</tr>
<tr>
<td></td>
<td>7,900</td>
<td>7,000</td>
<td></td>
<td>1,750</td>
<td>9,184</td>
</tr>
</tbody>
</table>

Note: β = balancing figure
Workings

1  **Goodwill**

<table>
<thead>
<tr>
<th></th>
<th>Units</th>
<th>Units</th>
<th>Rate</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred</td>
<td>4,500</td>
<td>4.5</td>
<td></td>
<td>1,000</td>
</tr>
<tr>
<td>Non-controlling interests (30% × 3,375)</td>
<td>1,012</td>
<td>4.5</td>
<td></td>
<td>225</td>
</tr>
<tr>
<td>Share capital</td>
<td>2,250</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained reserves</td>
<td>1,125</td>
<td></td>
<td>4.5</td>
<td>(750)</td>
</tr>
<tr>
<td></td>
<td>(3,375)</td>
<td>4.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2,137</td>
<td>4.5</td>
<td></td>
<td>475</td>
</tr>
<tr>
<td>Exchange gain 20X5–20X6 b/f</td>
<td></td>
<td>β</td>
<td></td>
<td>22</td>
</tr>
<tr>
<td>At 31.12.X6</td>
<td>2,137</td>
<td>4.3</td>
<td></td>
<td>497</td>
</tr>
<tr>
<td>Exchange gain 20X7</td>
<td></td>
<td>β</td>
<td></td>
<td>37</td>
</tr>
<tr>
<td>At 31.12.X7</td>
<td>2,137</td>
<td>4</td>
<td></td>
<td>534</td>
</tr>
</tbody>
</table>

Note: Goodwill is initially measured in the **subsidiary's currency**, then retranslated at each year-end so that we can identify the cumulative exchange differences. In the consolidated statement of financial position these are taken to reserves (see working 2)

2  **Retained reserves carried forward**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>T</td>
<td>4,400</td>
</tr>
<tr>
<td>S (800 (SOFP) × 70%)</td>
<td>560</td>
</tr>
<tr>
<td>Goodwill – exchange gain ((W1) 22 + 37)</td>
<td>59</td>
</tr>
<tr>
<td></td>
<td>5,019</td>
</tr>
</tbody>
</table>

Note: The post-acquisition reserves of S have been taken from the translated statement of financial position of S, where they were calculated as a balancing figure.

3  **Non-controlling interests (SOFP)**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>NCI at acquisition (W1)</td>
<td>225</td>
</tr>
<tr>
<td>Add: NCI share of post-acquisition retained reserves of S (800 (SOFP) × 30%)</td>
<td>240</td>
</tr>
<tr>
<td></td>
<td>465</td>
</tr>
</tbody>
</table>

**Statement of profit or loss and other comprehensive income**

Again this has been laid out with the separate statements for the parent and subsidiary alongside the solution. The following table includes:

- The separate statements of profit or loss and other comprehensive income of T and S, each in their own currency (these would normally be given within the question information)
- A column showing the exchange rates chosen to translate S's balances into $
- A column showing the translated statement of profit or loss and other comprehensive income of S
- A final column showing the consolidated statement of profit or loss and other comprehensive income for the T Group (consolidation workings are shown below the table)
## Statements of Profit or Loss and Other Comprehensive Income

For the Year Ended 31 December 20X7

<table>
<thead>
<tr>
<th></th>
<th>T</th>
<th>S</th>
<th>Rate</th>
<th>S</th>
<th>Consol</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>Units</td>
<td></td>
<td>$</td>
<td></td>
</tr>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>12,000</td>
<td>5,700</td>
<td>3.8</td>
<td>1,500</td>
<td>13,500</td>
</tr>
<tr>
<td><strong>Cost of sales</strong></td>
<td>(7,000)</td>
<td>(2,470)</td>
<td>3.8</td>
<td>(650)</td>
<td>(7,650)</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>5,000</td>
<td>3,230</td>
<td>850</td>
<td>5,850</td>
<td></td>
</tr>
<tr>
<td><strong>Operating expenses</strong></td>
<td>(3,025)</td>
<td>(570)</td>
<td>3.8</td>
<td>150</td>
<td>(3,175)</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>1,975</td>
<td>2,660</td>
<td>700</td>
<td>2,675</td>
<td></td>
</tr>
<tr>
<td><strong>Income tax expense</strong></td>
<td>(500)</td>
<td>(760)</td>
<td>3.8</td>
<td>(200)</td>
<td>(700)</td>
</tr>
<tr>
<td><strong>Profit for the year</strong></td>
<td>1,475</td>
<td>1,900</td>
<td>500</td>
<td>1,975</td>
<td></td>
</tr>
</tbody>
</table>

**Other comprehensive income:**

Exchange difference on translating foreign operations (W4) | 87

Total comprehensive income for the year | 2,062

Profit attributable to:

Equity holders of the parent | 1,825
Non-controlling interests (500 (from S's translated profit) × 30%) | 150

Total comprehensive income attributable to:

Owners of the parent (2,062 – 165) | 1,897
Non-controlling interests ((500 (S's translated profit) + 50 (W4)) × 30%) | 165

Total comprehensive income attributable to: | 2,062

### Notes:

1. It is worth noticing that you can translate the subsidiary's figures, complete the consolidation as far as the profit for the year and complete the reconciliation of profit showing amounts attributable to the owners of the parent and to the non-controlling interest before calculating the exchange difference.

2. The total exchange differences arising are shown as other comprehensive income in the consolidated statement of financial position, but the non-controlling interest only includes the NCI share of the exchange difference on retranslating S's net assets. This is because there is no NCI in goodwill in this example as the group uses the proportionate method to measure non-controlling interests at acquisition.

### Workings (continued)

4. **Exchange differences in period (gross)**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>On translation of net assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Closing NA @ CR (6,200 @ 4)</td>
<td>1,550</td>
<td></td>
</tr>
<tr>
<td>Opening NA @ OR ((Units 6,200 –1,900) @ 4.3)</td>
<td>1,000</td>
<td>550</td>
</tr>
<tr>
<td>Less: Retained profit as translated</td>
<td>(500)</td>
<td></td>
</tr>
<tr>
<td><strong>On goodwill (W1)</strong></td>
<td>37</td>
<td>87</td>
</tr>
</tbody>
</table>

Note: The closing net asset figure is taken from S's local currency statement of financial position and translated at the year-end rate. The opening net asset figure is calculated by deducting S's profit for the year to work back to the opening figure, then translating it at the prior year's closing rate.
### Statement of changes in equity

**CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT) FOR THE YEAR ENDED 31 DECEMBER 20X7**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 31 December 20X6 (2,000 + (W5) 3,122)</td>
<td>5,122</td>
</tr>
<tr>
<td>Total comprehensive income for the year</td>
<td>1,897</td>
</tr>
<tr>
<td>Balance at 31 December 20X7 (per SOFP)</td>
<td>7,019</td>
</tr>
</tbody>
</table>

#### 5 Retained reserves brought forward

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>T per question (4,400 – 1,475)</td>
<td>2,925</td>
</tr>
<tr>
<td>S NA b/f (W4)</td>
<td>1,000</td>
</tr>
<tr>
<td>NA at acquisition (see S's translated SOFP)</td>
<td>(750)</td>
</tr>
<tr>
<td></td>
<td>250</td>
</tr>
<tr>
<td>S – Group share (250 × 70%)</td>
<td>175</td>
</tr>
<tr>
<td>Exchange gain on goodwill b/f (W1)</td>
<td>22</td>
</tr>
<tr>
<td></td>
<td>3,122</td>
</tr>
</tbody>
</table>

### EXAM SKILLS

Note: If a question like this appears in the exam, notice that once you have completed the other requirements, you can take the year-end figure for equity from the consolidated statement of financial position, and the total comprehensive income for the year from the statement of profit or loss and other comprehensive income. At that point you could fill in a balancing figure for the brought forward balance. It can also be calculated by adding the parent's share capital to the brought forward group retained reserves (see working below).

### SECTION SUMMARY

Goodwill and fair value adjustments arising on the acquisition of a foreign operation should be treated as assets and liabilities of the acquired entity and translated at the **closing rate**.

The non-controlling interest in other comprehensive income will include the NCI's share of exchange differences on translating the subsidiary but exclude exchange differences arising on retranslating goodwill unless NCI is measured at fair value.
Chapter Roundup

SFRS(I) 1-21 Group Financial Statements

Asset and liabilities
- Translated at closing rate
- Goodwill and fair value adjustments translated at closing rate

Income and expenses
- Translated at transaction date rate (approximated to average rate)
- NCI in other comprehensive income
  - Includes share of exchange differences on translation of subsidiary
  - Excludes exchange differences on retranslation of goodwill unless NCI at fair value

Exchange gains and losses are reported in other comprehensive income and accumulated in separate component of equity
Quick Quiz

1. What factors must management take into account when determining the functional currency of a foreign operation?

2. How is the exchange difference on translating financial statements from functional to presentation currency calculated?

3. How should goodwill and fair value adjustments be treated on consolidation of a foreign operation?
Answers to Quick Quiz

1. See section 1.2

2. As the difference between opening net assets at the opening rate and closing rate plus the difference between retained profits at the average rate and closing rate.

3. Treat as assets/liabilities of the foreign operation and translate at the closing rate.

Answers to Question

29.1 Consolidated financial statements

The statement of financial position of X Inc at 31 December 20X9, other than share capital and retained earnings, should be translated at €1 = $1.

SUMMARISED STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X9

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td>300</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>200</td>
</tr>
<tr>
<td>Receivables</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>300</td>
</tr>
<tr>
<td></td>
<td>600</td>
</tr>
<tr>
<td>Non-current liabilities</td>
<td>110</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>110</td>
</tr>
</tbody>
</table>

.: Shareholders' funds = 600 – 110 – 110 = $380

Since Z Co acquired the whole of the issued share capital on incorporation, the post-acquisition retained earnings including exchange differences will be the value of shareholders' funds arrived at above, less the original cost to Z Co of $25.


SUMMARISED CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td>$(350 + 300)</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>$(225 + 200)</td>
</tr>
<tr>
<td>Receivables</td>
<td>$(150 + 100)</td>
</tr>
<tr>
<td></td>
<td>650</td>
</tr>
<tr>
<td></td>
<td>425</td>
</tr>
<tr>
<td></td>
<td>250</td>
</tr>
<tr>
<td></td>
<td>675</td>
</tr>
<tr>
<td></td>
<td>1,325</td>
</tr>
<tr>
<td>Equity and liabilities</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>Ordinary $1 shares (Z only)</td>
<td>300</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>$(300 + 355)</td>
</tr>
<tr>
<td></td>
<td>655</td>
</tr>
<tr>
<td></td>
<td>955</td>
</tr>
<tr>
<td>Non-current liabilities: loans</td>
<td>$(50 + 110)</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>$(100 + 110)</td>
</tr>
<tr>
<td></td>
<td>160</td>
</tr>
<tr>
<td></td>
<td>210</td>
</tr>
<tr>
<td></td>
<td>1,325</td>
</tr>
</tbody>
</table>
The statement of profit or loss and other comprehensive income should be translated at average rate ($1.6 = $1).

X INC
SUMMARISED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax (160/1.6)</td>
<td>100</td>
</tr>
<tr>
<td>Tax (80/1.6)</td>
<td>50</td>
</tr>
<tr>
<td>Profit after tax (80/1.6)</td>
<td>50</td>
</tr>
</tbody>
</table>

SUMMARISED CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax</td>
<td>$(200 + 100) 300</td>
</tr>
<tr>
<td>Tax</td>
<td>$(100 + 50) 150</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>$(100 + 50) 150</td>
</tr>
</tbody>
</table>

The statement of profit or loss and other comprehensive income cannot be completed until the exchange difference has been calculated.

The equity interest at the beginning of the year can be found as follows.

<table>
<thead>
<tr>
<th></th>
<th>€</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity value at 31 December 20X9</td>
<td>380</td>
</tr>
<tr>
<td>Retained profit for year</td>
<td>80</td>
</tr>
<tr>
<td>Equity value at 31 December 20X8</td>
<td>300</td>
</tr>
<tr>
<td>Translated at €2 = $1, this gives</td>
<td>$150</td>
</tr>
</tbody>
</table>

The exchange difference can now be calculated and the statement of profit or loss and other comprehensive income completed.

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity interest at 1 January 20X9 (opening rate)</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Equity interest at 1 January 20X9 (closing rate)</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Exchange gain</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Retained profit (average rate)</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>Retained profit (closing rate)</td>
<td>80</td>
<td></td>
</tr>
<tr>
<td>Exchange gain</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Total exchange gain</td>
<td>180</td>
<td></td>
</tr>
</tbody>
</table>

SUMMARISED CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax</td>
<td>$(200 + 100) 300</td>
</tr>
<tr>
<td>Tax</td>
<td>$(100 + 50) 150</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>$(100 + 50) 150</td>
</tr>
<tr>
<td>Other comprehensive income (items that may be re-classified to profit or loss*)</td>
<td></td>
</tr>
<tr>
<td>Exchange difference on translating foreign operations</td>
<td>180</td>
</tr>
<tr>
<td>Total comprehensive income</td>
<td>330</td>
</tr>
</tbody>
</table>

*Entities are required to group items presented in other comprehensive income (OCI) on the basis of whether they will be reclassified to (recycled through) profit or loss at a later date, in accordance with SFRS(I)s (SFRS(I) 1-1 paragraph 82A).
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (EXTRACT FOR RESERVES)
FOR THE YEAR ENDED 31 DECEMBER 20X9

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated reserves at 31 December 20X8</td>
<td>325</td>
</tr>
<tr>
<td>Total comprehensive income</td>
<td>330</td>
</tr>
<tr>
<td>Consolidated reserves at 31 December 20X9</td>
<td>655</td>
</tr>
</tbody>
</table>

(Note: The post-acquisition reserves of X Inc at the beginning of the year must have been $150 – $25 = $125 and the reserves of Z Co must have been $300 – $100 = $200. The consolidated reserves must therefore have been $325.)
A statement of cash flows is an additional primary statement of great value to users of financial statements for the extra information it provides.

You should be familiar with the basic principles, techniques and definitions relating to statements of cash flows from your earlier studies. This chapter develops the principles and preparation techniques to include a consolidated statement of cash flows.
Syllabus Handbook

<table>
<thead>
<tr>
<th>Learning outcome</th>
<th>Cognitive level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group Accounting</td>
<td>3</td>
</tr>
</tbody>
</table>

Determine and apply appropriate consolidation procedures to be used in preparing group financial statements, including statements of cash flows.

ESSENTIAL READING

SFRS(I) 1-7 Statement of Cash Flows, SFRS(I) 1-7 Illustrative Examples

1 Cash flows

SECTION INTRODUCTION

Statements of cash flows provide additional information for the users of financial statements and are mandated by SFRS(I) 1-1 Presentation of Financial Statements and the Companies Act.

Up until this chapter, application of SFRS(I)s has been on an accruals basis. Accrual accounting measures the financial performance and changes in equity of an entity over a specified reporting period and determines the financial position of that entity as at the end of that reporting period. In preparing the statements of financial performance, financial position, and changes in equity, recognition of revenues, expenses, assets, liabilities, and equity occurs in the reporting period to which the activities relate, regardless of when cash is received or paid out.

Nonetheless, this does not mean that information about cash and cash equivalents is less important than the other elements of the financial statements. The wise and efficient use of cash and cash equivalents is integral to management’s assessment of an entity’s ability to continue as a going concern (SFRS(I) 1-1 paragraph 25). In addition, users of the financial statements assess the ability of the entity to generate cash and cash equivalents as part of their economic decision-making process. As such, the provision of information about the historical changes in cash and cash equivalents of an entity (information that is not readily discernible from the other accruals-based statements) assists both management and users of financial statements to make informed and prudent decisions.

There are also other stakeholders that are interested in an entity’s ability to generate cash and cash equivalents, such as creditors and employees. This is because employees usually receive their salary in cash. Likewise, creditors are usually paid in cash for goods and services provided. In these two examples, cash can be physical or a cash equivalent such as a cheque or direct bank transfer.

While profit is often a key performance indicator, the continued survival and future prosperity of an entity depends not so much on profits as on its ability to generate cash to pay its debts as and when they fall due (solvency statement).
SECTION SUMMARY

Statements of cash flows are a useful addition to the financial statements of entities because it is recognised that accounting profit is not the only indicator of an entity's performance.

Statements of cash flows concentrate on the sources and uses of cash and are a useful indicator of an entity's liquidity and solvency.

2 SFRS(I) 1-7 Statement of Cash Flows: single company

SECTION INTRODUCTION

SFRS(I) 1-7 provides the format of a statement of cash flows and provides guidance as to how cash flows are grouped for presentation purposes.

The aim of SFRS(I) 1-7 is to provide information to users of financial statements about the entity's ability to generate cash and cash equivalents, as well as indicating the cash needs of the entity. The statement of cash flows provides historical information about cash and cash equivalents, classifying cash flows between operating, investing and financing activities.

2.1 Scope

A statement of cash flows must be presented as an integral part of an entity's financial statements. All types of entity can provide useful information about cash flows as the need for cash is universal, whatever the nature of their revenue-producing activities. Therefore all entities are required by the standards to produce a statement of cash flows.

2.2 Benefits of cash flow information

The use of statements of cash flows is very much in conjunction with the rest of the financial statements. Users can gain further appreciation of the change in net assets, of the entity's financial position (liquidity and solvency) and the entity's ability to adapt to changing circumstances by affecting the amount and timing of cash flows. Statements of cash flows enhance comparability as they are not affected by differing accounting policies used for the same type of transactions or events.

Cash flow information of a historical nature can be used as an indicator of the amount, timing and certainty of future cash flows. Past forecast cash flow information can be checked for accuracy as actual figures emerge. The relationship between profit and cash flows can be analysed as can changes in prices over time.
2.3 Definitions

The standard gives the following definitions, the most important of which are cash and cash equivalents.

**KEY TERMS**

**CASH** comprises cash on hand and demand deposits.

**CASH EQUIVALENTS** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

**CASH FLOWS** are inflows and outflows of cash and cash equivalents.

**OPERATING ACTIVITIES** are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

**INVESTING ACTIVITIES** are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

**FINANCING ACTIVITIES** are activities that result in changes in the size and composition of the equity contributed and borrowings of the entity. (SFRS(I) 1-7)

2.4 Cash and cash equivalents

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. To fulfil the above definition, an investment’s **maturity date should normally be within three months from its acquisition date**. It would usually be the case then that equity investments (ie shares in other companies) are not cash equivalents. An exception would be where redeemable preferred shares were acquired with a very close maturity date.

**Loans and other borrowings** from banks are classified as financing activities. In some countries, however, **bank overdrafts** are repayable on demand and are treated as part of an entity’s total cash management system. In these circumstances an overdrawn balance will be included in cash and cash equivalents. Such banking arrangements are characterised by a balance which fluctuates between overdrawn and credit.

**Movements** between different types of cash and cash equivalent are not included in cash flows. The investment of surplus cash in cash equivalents is part of cash management, not part of operating, investing or financing activities.

2.5 Presentation of a statement of cash flows

SFRS(I) 1-7 requires statements of cash flows to report cash flows during the period classified by operating, investing and financing activities.

The manner of presentation of cash flows from operating, investing and financing activities depends on the nature of the entity. By classifying cash flows between different activities in this way users can see the impact on cash and cash equivalents of each class of activity, and their relationships with each other. We can look at each in more detail.

2.5.1 Operating activities

This is the key part of the statement of cash flows because it shows whether, and to what extent, companies **generate cash from their operations**. It is these operating cash flows which must, in the end pay for all cash outflows relating to other activities, ie paying loan interest, dividends and so on.
Most of the components of cash flows from operating activities will be those items which determine the net profit or loss of the entity, i.e., they relate to the main revenue-producing activities of the entity. The standard gives the following as examples of cash flows from operating activities.

(a) Cash receipts from the sale of goods and the rendering of services
(b) Cash receipts from royalties, fees, commissions and other revenue
(c) Cash payments to suppliers for goods and services
(d) Cash payments to and on behalf of employees
(e) Cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits
(f) Cash payments/refunds of income taxes unless they can be specifically identified with financing or investing activities
(g) Cash receipts and payments from contracts held for dealing or trading purposes

Certain items may be included in the net profit or loss for the period which do not relate to operational cash flows, for example the profit or loss on the sale of a piece of plant will be included in net profit or loss, but the cash flows will be classed as investing.

2.5.2 Investing activities

The cash flows classified under this heading show the extent of new investment in assets which are expected to generate future profit and positive cash flows. The standard gives the following examples of cash flows arising from investing activities.

(a) Cash payments to acquire property, plant and equipment, intangibles and other long-term assets, including those relating to capitalised development costs and self-constructed property, plant and equipment
(b) Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets
(c) Cash payments to acquire shares or debentures of other entities
(d) Cash receipts from sales of shares or debentures of other entities
(e) Cash advances and loans made to other parties
(f) Cash receipts from the repayment of advances and loans made to other parties
(g) Cash payments for or receipts from futures/forward/option/swap contracts except where the contracts are held for dealing purposes, or the payments/receipts are classified as financing activities

2.5.3 Financing activities

This section of the statement of cash flows shows the share of cash which the entity’s capital providers have claimed during the period. The standard gives the following examples of cash flows which might arise under these headings.

(a) Cash proceeds from issuing shares or other equity instruments
(b) Cash payments to owners to acquire or redeem the entity's shares
(c) Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings
(d) Cash repayments of amounts borrowed
(e) Cash payments by a lessee for the reduction of the outstanding liability relating to a lease
2.5.4 Reporting cash flows on a net basis

SFRS(I) 1-7 allows certain cash flows to be reported on a net basis. They are:

(a) Cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than the entity (for example rents collected on behalf of and paid over to owners of properties by a rental agency)

(b) Cash receipts and payments for items in which the turnover is quick, amounts are large and maturities are short (for example the purchase and sale of investments)

(c) For a financial institution:
   (i) Cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date
   (ii) The placement of deposits and withdrawal of deposits from other financial institutions
   (iii) Cash advances and loans made to customers and the repayment of those advances and loans

2.6 Reporting cash flows from operating activities

The standard offers a choice of method for this part of the statement of cash flows.

(a) **Direct method**: disclose major classes of gross cash receipts and gross cash payments

(b) **Indirect method**: net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows

The **direct method** is preferred by standard setters because it discloses information, not available elsewhere in the financial statements, which could be of use in estimating future cash flows. The example below shows both methods.

### 2.6.1 Using the direct method

There are different ways in which the **information about gross cash receipts and payments** can be obtained. The most obvious way is simply to extract the information from the accounting records. This may be a laborious task, however, and the indirect method below may be easier. However, entities are encouraged (but not required) to report cash flows from operating activities using the direct method (SFRS(I) 1-7 paragraph 19).

### 2.6.2 Using the indirect method

This method is undoubtedly **easier** from the point of view of the preparer of the statement of cash flows. The net profit or loss for the period is adjusted for the following.

(a) Changes during the period in inventories, operating receivables and payables

(b) Non-cash items, eg depreciation, provisions, profits/losses on the sales of assets

(c) Other items, the cash flows from which should be classified under investing or financing activities.

A **proforma** of such a calculation is as follows and this method may be more common in the exam.
It is important to understand why certain items are added and others subtracted. Note the following points.

(a) Depreciation is not a cash expense, but is deducted in arriving at the profit figure in the statement of comprehensive income. It makes sense, therefore, to eliminate it by adding it back. A similar principle applies to amortisation.

(b) By the same logic, a loss on a disposal of a non-current asset (arising through underprovision of depreciation) needs to be added back and a gain on disposal deducted.

(c) An increase in inventories means less cash – you have spent cash on buying inventory.

(d) An increase in receivables means the company's credit customers have not paid as much, and therefore there is less cash.

(e) If we pay off payables, causing the figure to decrease, again we have less cash.

Note: The proforma above reconciles profit before tax to cash flows from operating activities. This is the approach adopted in SFRS(I) 1-7 Illustrative Examples. In practice some companies reconcile profit after tax eg CapitaLand). Where this approach is adopted a further reconciling item is required, adding the tax charge back to profits. This is essentially a presentation issue and does not change the cash flow from operating activities figure itself.

2.6.3 Indirect versus direct

The direct method is encouraged where the necessary information is not too costly to obtain, but SFRS(I) 1-7 does not require it, and the direct method will involve more work in preparation than the indirect method. It is not obvious that SFRS(I) 1-7 is right in permitting the indirect method. It could be argued that companies ought to monitor their cash flows carefully enough on an ongoing basis to be able to use the direct method at minimal extra cost.

2.7 Interest and dividends

Cash flows from interest and dividends received and paid should each be disclosed separately. Each should be classified in a consistent manner from period to period as either operating, investing or financing activities.

Dividends paid by the entity can be classified in one of two ways.

(a) As a financing cash flow, showing the cost of obtaining financial resources.

(b) As a component of cash flows from operating activities so that users can assess the entity's ability to pay dividends out of operating cash flows.
2.8 Taxes on income

Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing or investing activities.

Taxation cash flows are often difficult to match to the originating underlying transaction, so most of the time all tax cash flows are classified as arising from operating activities.

2.9 Disclosures

2.9.1 Non-cash transactions

Investing and financing transactions that do not involve the use of cash (and so are excluded from the statement of cash flows) should be disclosed elsewhere in the financial statements. This helps users to gain an understanding of the capital and asset structure of the entity and possible future cash flows. Non-cash transactions that should be disclosed include:

- The acquisition of assets by way of a lease
- The acquisition of an entity by way of a share-for-share exchange
- A bonus issue of shares
- The conversion of debt to equity

2.9.2 Changes in liabilities arising from financing activities

Liabilities arising from financing activities are liabilities for which cash flows were, or future cash flows will be, classified as cash flows from financing activities. The disclosure requirements also relate to changes in financial assets if they meet this definition.

Disclosure should be provided of changes in these liabilities (assets). The required disclosures may be (but are not required to be) provided in the format of a reconciliation from opening to closing balances and should include detail of the following:

- Changes from financing cash flows
- Changes as a result of obtaining control of or losing control of subsidiaries or other businesses
- The effect of changes in foreign exchange rates
- Changes in fair values
- Other changes

An example disclosure note is as follows:

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>Cash flow</th>
<th>Non-cash changes</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
</tr>
<tr>
<td>Long-term borrowings</td>
<td>1,040</td>
<td>250</td>
<td>200</td>
<td>–</td>
</tr>
<tr>
<td>Lease liabilities</td>
<td>–</td>
<td>(90)</td>
<td>–</td>
<td>900</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>1,040</td>
<td>160</td>
<td>200</td>
<td>900</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2,300</td>
</tr>
</tbody>
</table>

2.9.3 Components of cash and cash equivalents

The components of cash and cash equivalents should be disclosed and a reconciliation should be disclosed in a note, showing the amounts in the statement of cash flows reconciled with the equivalent items reported in the statement of financial position.

It is also necessary to disclose the accounting policy used in deciding the items included in cash and cash equivalents, in accordance with SFRS(I) 1-1, but also because of the wide range of cash management practices worldwide. When there is a change in accounting policy on cash and cash equivalents, it should be dealt with in accordance with SFRS(I) 1-8 and the effect should be disclosed.
2.9.4 Other disclosures

Entities must disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances that are not available for use by the group.

All entities are encouraged to disclose any other information likely to be of importance.

(a) Restrictions on the use of or access to any part of cash equivalents
(b) The amount of undrawn borrowing facilities which are available
(c) Cash flows which increased operating capacity compared to cash flows which merely maintained operating capacity
(d) The amount of cash flows arising from the operating, investing and financing activities of each reportable segment as defined by SFRS(I) 8

2.10 Example of a statement of cash flows

In the next section we will look at the procedures for preparing a statement of cash flows. First, look at this example, adapted from SFRS(I) 1-7 Illustrative Examples.

2.10.1 Direct method

STATEMENT OF CASH FLOWS (DIRECT METHOD)
YEAR ENDED 31 DECEMBER 20X7

<table>
<thead>
<tr>
<th></th>
<th>$m</th>
<th>$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flows from operating activities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash receipts from customers</td>
<td>30,150</td>
<td></td>
</tr>
<tr>
<td>Cash paid to suppliers and employees</td>
<td>(27,600)</td>
<td></td>
</tr>
<tr>
<td>Cash generated from operations</td>
<td>2,550</td>
<td></td>
</tr>
<tr>
<td>Interest paid</td>
<td>(270)</td>
<td></td>
</tr>
<tr>
<td>Income taxes paid</td>
<td>(900)</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash from operating activities</strong></td>
<td>1,380</td>
<td></td>
</tr>
<tr>
<td>Cash flows from investing activities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of property, plant and equipment</td>
<td>(900)</td>
<td></td>
</tr>
<tr>
<td>Proceeds from sale of equipment</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Interest received</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Dividends received</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash used in investing activities</strong></td>
<td>(480)</td>
<td></td>
</tr>
<tr>
<td>Cash flows from financing activities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds from issue of share capital</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>Proceeds from long-term borrowings</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>Payment of lease liabilities</td>
<td>(90)</td>
<td></td>
</tr>
<tr>
<td>Dividends paid*</td>
<td>(1,200)</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash used in financing activities</strong></td>
<td>(790)</td>
<td></td>
</tr>
<tr>
<td><strong>Net increase in cash and cash equivalents</strong></td>
<td>110</td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents at beginning of period (Note)</td>
<td>120</td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents at end of period (Note)</td>
<td>230</td>
<td></td>
</tr>
</tbody>
</table>

* This could also be shown as an operating cash flow
2.10.2 Indirect method

STATEMENT OF CASH FLOWS (INDIRECT METHOD)
YEAR ENDED 31 DECEMBER 20X7

<table>
<thead>
<tr>
<th>Cash flows from operating activities</th>
<th>$m</th>
<th>$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before taxation</td>
<td>3,390</td>
<td></td>
</tr>
<tr>
<td>Adjustments for:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>450</td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>(500)</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3,740</td>
<td></td>
</tr>
<tr>
<td>Increase in trade and other receivables</td>
<td>(500)</td>
<td></td>
</tr>
<tr>
<td>Decrease in inventories</td>
<td>1,050</td>
<td></td>
</tr>
<tr>
<td>Decrease in trade payables</td>
<td>(1,740)</td>
<td></td>
</tr>
<tr>
<td>Cash generated from operations</td>
<td>2,550</td>
<td></td>
</tr>
<tr>
<td>Interest paid</td>
<td>(270)</td>
<td></td>
</tr>
<tr>
<td>Income taxes paid</td>
<td>(900)</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash from operating activities</strong></td>
<td>1,380</td>
<td></td>
</tr>
</tbody>
</table>

Cash flows from investing activities

| Purchase of property, plant and equipment | (900) |
| Proceeds from sale of equipment          | 20 |
| Interest received                        | 200 |
| Dividends received                       | 200 |
| **Net cash used in investing activities** | (480) |

Cash flows from financing activities

| Proceeds from issue of share capital    | 250 |
| Proceeds from long-term borrowings      | 250 |
| Payment of lease liabilities            | (90) |
| Dividends paid*                         | (1,200) |
| **Net cash used in financing activities** | (790) |

**Net increase in cash and cash equivalents** | 110 |
**Cash and cash equivalents at beginning of period (Note)** | 230 |
**Cash and cash equivalents at end of period (Note)** | 230 |

* This could also be shown as an operating cash flow

---

**Note showing components of cash and cash equivalents**

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on hand and balances with banks</td>
<td>40</td>
<td>25</td>
</tr>
<tr>
<td>Short-term investments</td>
<td>190</td>
<td>95</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>230</td>
<td>120</td>
</tr>
</tbody>
</table>
2.11 Approach to preparing a statement of cash flows

The following approach should be used in the preparation of a statement of cash flows using the indirect method.

**STEP 1**
Set out the proforma leaving plenty of space.

**STEP 2**
Complete the reconciliation of profit before tax to net cash from operating activities, as far as possible.

**STEP 3**
Calculate the following where appropriate.
- Tax paid
- Dividends paid
- Purchase and sale of non-current assets for cash
- Issues of shares
- Repayment of loans

**STEP 4**
Work out the profit if not already given using: opening and closing retained profits balances, tax charge and dividends.

**STEP 5**
Complete the note of gross cash flows. Alternatively the information may go straight into the statement.

**STEP 6**
Slot the figures into the statement and prepare any further notes required.

**Question 30.1 Single company**

Queenstown Catering Ltd's statement of profit or loss and other comprehensive income for the year ended 31 December 20X8 and statements of financial position at 31 December 20X7 and 31 December 20X8 were as follows.

QUEENSTOWN CATERING LTD
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X8

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>720</td>
<td></td>
</tr>
<tr>
<td>Raw materials consumed</td>
<td>70</td>
<td></td>
</tr>
<tr>
<td>Staff costs</td>
<td>94</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>118</td>
<td></td>
</tr>
<tr>
<td>Loss on disposal of long-term asset</td>
<td>18</td>
<td></td>
</tr>
</tbody>
</table>
During the year, the company paid $90,000 for a new piece of machinery.

Required

Prepare a statement of cash flows for Queenstown Catering Ltd for the year ended 31 December 20X8 in accordance with the requirements of SFRS(I) 1-7, using the indirect method.

### SECTION SUMMARY

Cash flows are classified as operating, investing or financing cash flows. Cash flows from operating activities can be presented using the direct or indirect method. Although SFRS(I) 1-7 encourages entities to use the direct method, most companies in Singapore use the indirect method for reporting cash flows from operations.
3 Consolidated statements of cash flows

SECTION INTRODUCTION

Consolidated statements of cash flow may include cash flows arising from the acquisition or disposal of group companies, transactions with the non-controlling interest and transactions with associates and joint ventures.

Consolidated statements of cash flows follow the same principles as for single company statements, with some additional complications.

Cash flows that are internal to the group should be eliminated in the preparation of a consolidated statement of cash flows. Where a subsidiary joins or leaves a group during a financial year the cash flows of the group should include the cash flows of the subsidiary concerned for the same period as that for which the group’s statement of profit or loss and other comprehensive income includes the results of the subsidiary.

3.1 Acquisitions and disposals of subsidiaries and other business units

An entity should present separately the aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units and classify them as investing activities.

Disclosure is required of the following, in aggregate, in respect of both acquisitions and disposals of subsidiaries or other business units during the period.

- Total purchase/disposal consideration
- Portion of purchase/disposal consideration discharged by means of cash/cash equivalents
- Amount of cash/cash equivalents in the subsidiary or business unit disposed of
- Amount of assets and liabilities other than cash/cash equivalents in the subsidiary or business unit acquired or disposed of, summarised by major category

The amounts shown in the statement of cash flows for purchase or disposal of subsidiaries or business units will be the amounts paid or received net of cash/cash equivalents acquired or disposed of.

3.1.1 Changes in ownership that do not result in a loss of control

Where a parent company that is not an investment entity acquires a further interest in an existing subsidiary, or sells an interest in an existing subsidiary without losing control, the transaction is accounted for as an equity transaction. Accordingly the resulting cash flows are classified in the same way as other transactions with owners ie as financing transactions.

3.2 Consolidation adjustments and non-controlling interest

The group statement of cash flows should only deal with flows of cash and cash equivalents external to the group, so all intra-group cash flows should be eliminated. Dividends paid to non-controlling interest should be included under financing activities and disclosed separately.
Example

The following are extracts of the consolidated results for Jurong Textiles Ltd for the year ended 31 December 20X2.

**CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME**

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group profit before tax</td>
<td>90</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(30)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>60</td>
</tr>
<tr>
<td>Profit attributable to:</td>
<td></td>
</tr>
<tr>
<td>Owners of the parent</td>
<td>45</td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>60</td>
</tr>
</tbody>
</table>

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION (EXTRACT)**

<table>
<thead>
<tr>
<th></th>
<th>20X1 $'000</th>
<th>20X2 $'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-controlling interest</td>
<td>300</td>
<td>306</td>
</tr>
</tbody>
</table>

Calculate the dividends paid to the non-controlling interest during the year.

**Solution**

The non-controlling interest share of profit after tax represents retained profit plus dividends paid.

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend paid (balancing figure)</td>
<td>9</td>
</tr>
<tr>
<td>Balance b/fwd</td>
<td>300</td>
</tr>
<tr>
<td>Balance c/fwd</td>
<td>306</td>
</tr>
<tr>
<td>Profit for period (P/L)</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>315</td>
</tr>
</tbody>
</table>

### 3.3 Associates and joint ventures

As we saw in Chapter 26, an investment in associate is measured in the statement of financial position at cost plus the parent’s share of post-acquisition total comprehensive income less dividends received.

An entity that reports an interest in an associate or a joint venture using the equity method includes in its statement of cash flows the cash flows in respect of its investments in the associate or joint venture, and distributions and other payments or receipts between it and the associate or joint venture.

Dividends should be included in **operating or investing cash flows**.
Example

The following are extracts of the consolidated results of Pripon Ltd for the year ended 31 December 20X2.

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group profit before tax</td>
<td>150</td>
</tr>
<tr>
<td>Share of associate's profit after tax</td>
<td>30</td>
</tr>
<tr>
<td>Tax (group)</td>
<td>75</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>105</td>
</tr>
</tbody>
</table>

CONSOLIDATED STATEMENT OF FINANCIAL POSITION (EXTRACTS)

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in associate</td>
<td>264</td>
<td>276</td>
</tr>
</tbody>
</table>

Calculate the dividend received from the associate during the year.

Solution

The associate profit after tax represents retained profit plus dividend.

<table>
<thead>
<tr>
<th>ASSOCIATE</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance b/fwd</td>
<td>264</td>
</tr>
<tr>
<td>Dividend from associate (balancing figure)</td>
<td>18</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>30</td>
</tr>
<tr>
<td>Balance c/fwd</td>
<td>276</td>
</tr>
</tbody>
</table>

Question 30.2

Somerset Sculptures Co is a 40 year old company producing garden statues carved from marble. Twenty-two years ago it acquired a 100% interest in a marble importing company, Lucky Stone Co. In 20W9 it acquired a 40% interest in a competitor, Landscapes Co (which did not in Somerset Sculptures’ view give it control) and on 1 January 20X7 it acquired a 75% interest in Garden Furniture Designs. The draft consolidated accounts for the Somerset Sculptures Group are as follows.

DRAFT CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating profit</td>
<td>4,455</td>
</tr>
<tr>
<td>Share of profit after tax of associate</td>
<td>1,050</td>
</tr>
<tr>
<td>Income from long-term investment</td>
<td>600</td>
</tr>
<tr>
<td>Interest payable</td>
<td>(450)</td>
</tr>
<tr>
<td>Profit before taxation</td>
<td>5,655</td>
</tr>
<tr>
<td>Tax on profit</td>
<td></td>
</tr>
<tr>
<td>Income tax</td>
<td>1,173</td>
</tr>
<tr>
<td>Deferred taxation</td>
<td>312</td>
</tr>
<tr>
<td>Tax attributable to investment income</td>
<td>135</td>
</tr>
</tbody>
</table>
### Group statements of cash flows

#### PART G CONSOLIDATED FINANCIAL STATEMENTS

<table>
<thead>
<tr>
<th></th>
<th>20X6 $'000</th>
<th>20X7 $'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit for the year</td>
<td>(1,620)</td>
<td>4,035</td>
</tr>
<tr>
<td>Attributable to:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>owners of the parent</td>
<td>3,735</td>
<td></td>
</tr>
<tr>
<td>non-controlling</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>interest</td>
<td></td>
<td>4,035</td>
</tr>
</tbody>
</table>

#### DRAFT CONSOLIDATED STATEMENT OF FINANCIAL POSITION

**AS AT 31 DECEMBER**

<table>
<thead>
<tr>
<th></th>
<th>20X6 $'000</th>
<th>20X7 $'000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tangible assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings at carrying value</td>
<td>6,600</td>
<td>6,225</td>
</tr>
<tr>
<td>Machinery: cost</td>
<td>4,200</td>
<td>9,000</td>
</tr>
<tr>
<td>accumulated depreciation</td>
<td>(3,300)</td>
<td>(3,600)</td>
</tr>
<tr>
<td>carrying value</td>
<td>900</td>
<td>5,400</td>
</tr>
<tr>
<td></td>
<td>7,500</td>
<td>11,625</td>
</tr>
<tr>
<td>Goodwill</td>
<td>–</td>
<td>300</td>
</tr>
<tr>
<td>Investments in associates</td>
<td>3,000</td>
<td>3,300</td>
</tr>
<tr>
<td>Long-term investments</td>
<td>1,230</td>
<td>1,230</td>
</tr>
<tr>
<td></td>
<td>11,730</td>
<td>16,455</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>3,000</td>
<td>5,925</td>
</tr>
<tr>
<td>Receivables</td>
<td>3,825</td>
<td>5,550</td>
</tr>
<tr>
<td>Cash</td>
<td>5,460</td>
<td>13,545</td>
</tr>
<tr>
<td></td>
<td>12,285</td>
<td>25,020</td>
</tr>
<tr>
<td>Equity and liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>12,285</td>
<td>20,469</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>7,500</td>
<td>10,335</td>
</tr>
<tr>
<td></td>
<td>19,785</td>
<td>30,804</td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>–</td>
<td>345</td>
</tr>
<tr>
<td></td>
<td>19,785</td>
<td>31,149</td>
</tr>
<tr>
<td>Non-current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease liabilities</td>
<td>510</td>
<td>2,130</td>
</tr>
<tr>
<td>Loans</td>
<td>1,500</td>
<td>4,380</td>
</tr>
<tr>
<td>Deferred tax</td>
<td>39</td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>2,049</td>
<td>6,600</td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade payables</td>
<td>840</td>
<td>1,500</td>
</tr>
<tr>
<td>Lease liabilities</td>
<td>600</td>
<td>720</td>
</tr>
<tr>
<td>Income tax</td>
<td>651</td>
<td>1,386</td>
</tr>
<tr>
<td>Accrued interest and finance charges</td>
<td>90</td>
<td>120</td>
</tr>
<tr>
<td></td>
<td>2,181</td>
<td>3,726</td>
</tr>
<tr>
<td></td>
<td>24,015</td>
<td>41,475</td>
</tr>
</tbody>
</table>

**Notes:**

1. There had been no acquisitions or disposals of buildings during the year.

Machinery costing $1.5 million was sold for $1.5 million resulting in a profit of $300,000. New machinery was acquired in 20X7 including some items acquired by way of lease arrangements. The right-of-use assets arising at the start of these leases totalled $2.55 million, which was equal to the unadjusted present value of future lease payments. The right-of-use assets are included within the machinery balance in the statement of financial position as the financial controller at
Somerset Sculptures had not realised that SFRS(I) 16 requires them to be presented separately from other assets.

2 Information relating to the acquisition of Garden Furniture Designs

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>495</td>
</tr>
<tr>
<td>Inventories</td>
<td>96</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>84</td>
</tr>
<tr>
<td>Cash</td>
<td>336</td>
</tr>
<tr>
<td>Trade payables</td>
<td>(204)</td>
</tr>
<tr>
<td>Income tax</td>
<td>(51)</td>
</tr>
<tr>
<td></td>
<td>756</td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>(189)</td>
</tr>
<tr>
<td></td>
<td>567</td>
</tr>
<tr>
<td>Goodwill</td>
<td>300</td>
</tr>
<tr>
<td></td>
<td>867</td>
</tr>
<tr>
<td>2,640,000 shares issued as part consideration</td>
<td>825</td>
</tr>
<tr>
<td>Balance of consideration paid in cash</td>
<td>42</td>
</tr>
<tr>
<td></td>
<td>867</td>
</tr>
</tbody>
</table>

3 Loans were issued at a discount in 20X7 and the carrying amount of the loans at 31 December 20X7 included $120,000 representing the finance cost attributable to the discount and allocated in respect of the current reporting period.

4 There had been no change in the fair value of the long term investments held at $1,230 in the financial statements during 20X7.

Required

Prepare a consolidated statement of cash flows for the Somerset Sculptures Group for the year ended 31 December 20X7 as required by SFRS(I) 1-7, using the indirect method. There is no need to provide notes to the statement of cash flows.

Question 30.3 Consolidated cash flow 2

The following are extracts from the financial statements of Pacific Imports Ltd and one of its wholly owned subsidiaries, Asiatic Ltd, the shares in which were acquired on 31 October 20X2.

STATISTICS OF FINANCIAL POSITION

<table>
<thead>
<tr>
<th></th>
<th>Pacific Imports Ltd</th>
<th>Asiatic Ltd</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>31 December 20X2</td>
<td>31 December 20X1</td>
</tr>
<tr>
<td></td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant &amp; equipment</td>
<td>4,764</td>
<td>3,685</td>
</tr>
<tr>
<td>Goodwill</td>
<td>42</td>
<td></td>
</tr>
<tr>
<td>Investment in associates</td>
<td>2,195</td>
<td>2,175</td>
</tr>
<tr>
<td></td>
<td>7,001</td>
<td>5,860</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>1,735</td>
<td>1,388</td>
</tr>
<tr>
<td>Receivables</td>
<td>2,658</td>
<td>2,436</td>
</tr>
<tr>
<td>Bank balances and cash</td>
<td>43</td>
<td>77</td>
</tr>
<tr>
<td></td>
<td>4,436</td>
<td>3,901</td>
</tr>
<tr>
<td></td>
<td>11,437</td>
<td>9,761</td>
</tr>
</tbody>
</table>
### Equity

<table>
<thead>
<tr>
<th></th>
<th>Pacific Imports Ltd and subsidiaries</th>
<th>Asiatic Ltd</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>31 December 20X2</td>
<td>31 December 20X1</td>
</tr>
<tr>
<td>Share capital</td>
<td>$5,112</td>
<td>$4,776</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>$2,540</td>
<td>$2,063</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$7,652</td>
<td>$6,839</td>
</tr>
</tbody>
</table>

### Non-current liabilities

<table>
<thead>
<tr>
<th></th>
<th>Pacific Imports Ltd and subsidiaries</th>
<th>Asiatic Ltd</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>$1,348</td>
<td>$653</td>
</tr>
<tr>
<td>Deferred tax</td>
<td>$111</td>
<td>$180</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,459</td>
<td>$833</td>
</tr>
</tbody>
</table>

### Current liabilities

<table>
<thead>
<tr>
<th></th>
<th>Pacific Imports Ltd and subsidiaries</th>
<th>Asiatic Ltd</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payables</td>
<td>$1,915</td>
<td>$1,546</td>
</tr>
<tr>
<td>Bank overdrafts</td>
<td>$176</td>
<td>$343</td>
</tr>
<tr>
<td>Current tax payable</td>
<td>$235</td>
<td>$200</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$2,326</td>
<td>$2,089</td>
</tr>
</tbody>
</table>

### CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before interest and tax</td>
<td>546</td>
</tr>
<tr>
<td>Finance costs</td>
<td>–</td>
</tr>
<tr>
<td>Share of profit of associates</td>
<td>120</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>666</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>126</td>
</tr>
<tr>
<td><strong>PROFIT/TOTAL COMPREHENSIVE INCOME FOR THE YEAR</strong></td>
<td><strong>540</strong></td>
</tr>
<tr>
<td>Attributable to:</td>
<td></td>
</tr>
<tr>
<td>Owners of the parent</td>
<td>540</td>
</tr>
<tr>
<td>Non-controlling interests</td>
<td>–</td>
</tr>
</tbody>
</table>

The following information is also given:

(a) The consolidated figures at 31 December 20X2 include Asiatic Ltd.
(b) The amount of depreciation on property, plant and equipment during the year was $78,000. There were no disposals.
(c) The cost on 31 October 20X2 of the shares in Asiatic Ltd was $1,086,000 comprising the issue of $695,000 unsecured loan stock at par, 120,000 ordinary shares at a value of 280c and $55,000 in cash.
(d) No write down of goodwill was required during the period.
(e) Total dividends paid by Pacific Imports Ltd (parent) during the period amounted to $63,000.
(f) The bank overdraft is considered to be part of the cash management of the business.

**Required**

Prepare a consolidated statement of cash flows for Pacific Imports Ltd and subsidiaries for the year ended 31 December 20X2 using the indirect method.

Notes to the statement of cash flows are not required.
The preparation of consolidated statements of cash flows will, in many respects, be the same as those for single companies, with the following additional complications.

- Acquisitions and disposals of subsidiaries
- Cancellation of intra-group transactions
- Non-controlling interest
- Associates and joint ventures
Chapter Roundup

SFRS(I) 1-7
Statements of Cash Flows

- Operating
  - Direct method
  - Indirect method
- Investing
- Financing

Classification of cash flows

- Acquisitions and disposals
- Intra-group transactions
- Non-controlling interest
- Associates and joint ventures

Non-cash transactions
Changes in liabilities (financing activities)
Cash and cash equivalents
Other

Indicator of liquidity/solvency

DISCLOSURES
### Quick Quiz

1. What is the objective of SFRS(I) 1-7?
2. What are the benefits of cash flow information according to SFRS(I) 1-7?
3. What are the standard headings required by SFRS(I) 1-7 to be included in a statement of cash flows?
4. What is the 'indirect method' of preparing a statement of cash flows?
5. How should an acquisition or disposal of a subsidiary be shown in the statement of cash flows?
Answers to Quick Quiz

1. To provide users of financial statements with information about the entity's ability to generate cash and cash equivalents, and the entity's cash needs.

2. See section 2.2.

3. Operating, investing and financing activities.

4. The net profit or loss for the period is adjusted for non-cash items; changes in inventories, receivables and payables from operations; and other items resulting from investing or financing activities.

5. Cash flows from acquisitions and disposals are disclosed separately under investing activities.

Answers to Questions

30.1 Single company

QUEENSTOWN CATERING LTD
STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X8

<table>
<thead>
<tr>
<th>Cash flows from operating activities</th>
<th>$'000</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax</td>
<td>392</td>
<td></td>
</tr>
<tr>
<td>Interest payable</td>
<td></td>
<td>28</td>
</tr>
<tr>
<td>Depreciation charges</td>
<td></td>
<td>118</td>
</tr>
<tr>
<td>Loss on sale of tangible non-current assets</td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>Increase in inventories</td>
<td></td>
<td>(4)</td>
</tr>
<tr>
<td>Increase in receivables</td>
<td></td>
<td>(18)</td>
</tr>
<tr>
<td>Increase in payables</td>
<td></td>
<td>12</td>
</tr>
<tr>
<td>Cash generated from operations</td>
<td></td>
<td>546</td>
</tr>
<tr>
<td>Interest paid</td>
<td></td>
<td>(28)</td>
</tr>
<tr>
<td>Dividends paid (268 + 490 – 686)</td>
<td></td>
<td>(72)</td>
</tr>
<tr>
<td>Tax paid (86 + 124 – 102)</td>
<td></td>
<td>(108)</td>
</tr>
<tr>
<td><strong>Net cash from operating activities</strong></td>
<td></td>
<td><strong>338</strong></td>
</tr>
</tbody>
</table>

| Cash flows from investing activities |       |       |
| Payments to acquire tangible non-current assets |       | (90) |
| Receipts from sales of tangible non-current assets (W) |   | 12 |
| **Net cash used in investing activities** |   | **(78)** |

| Cash flows from financing activities |       |       |
| Issues of share capital (396 – 364) |       | 32    |
| Long-term loans repaid (500 – 200)  |       | (300) |
| **Net cash used in financing activities** |       | **(268)** |

| Decrease in cash and cash equivalents |       | (8) |
| Cash and cash equivalents at 1.1.X8  |       | 56  |
| Cash and cash equivalents at 31.12.X8 |       | 48  |
**Working: non-current asset disposals**

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>COST OF NON-CURRENT ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At 1.1.X8</td>
<td>1,560</td>
<td>1,596</td>
</tr>
<tr>
<td>Purchases</td>
<td>90</td>
<td>54</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,650</td>
<td>1,650</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ACCUMULATED DEPRECIATION</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At 31.12.X8</td>
<td>318</td>
<td>224</td>
</tr>
<tr>
<td>Depreciation on disposals (balance)</td>
<td>24</td>
<td>118</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>342</td>
<td>342</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CV of disposals (54 – 24)</td>
<td>30</td>
</tr>
<tr>
<td>Net loss reported</td>
<td>(18)</td>
</tr>
<tr>
<td>Proceeds of disposals</td>
<td>12</td>
</tr>
</tbody>
</table>

**30.2 Consolidated cash flow 1**

SOMERSET SCULPTURES CO

CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X7

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash flows from operating activities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net profit before tax</td>
<td>5,655</td>
<td></td>
</tr>
<tr>
<td>Adjustments for:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation (W1)</td>
<td>975</td>
<td></td>
</tr>
<tr>
<td>Profit on sale of plant</td>
<td>(300)</td>
<td></td>
</tr>
<tr>
<td>Share of associate's profits</td>
<td>(1,050)</td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>(600)</td>
<td></td>
</tr>
<tr>
<td>Interest payable</td>
<td>(450)</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>5,130</td>
<td></td>
</tr>
<tr>
<td>Increase in trade and other receivables (5,550 – 3,825 – 84)</td>
<td>(1,641)</td>
<td></td>
</tr>
<tr>
<td>Increase in inventories (5,925 – 3,000 – 96)</td>
<td>(2,829)</td>
<td></td>
</tr>
<tr>
<td>Increase in trade payables (1,500 – 840 – 204)</td>
<td>456</td>
<td></td>
</tr>
<tr>
<td><strong>Cash generated from operations</strong></td>
<td>1,116</td>
<td></td>
</tr>
<tr>
<td>Interest paid (W2)</td>
<td>(300)</td>
<td></td>
</tr>
<tr>
<td>Income taxes paid (W3)</td>
<td>(750)</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash from operating activities</strong></td>
<td>66</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash flows from investing activities</strong></td>
<td></td>
</tr>
<tr>
<td>Purchase of subsidiary (W4)</td>
<td>294</td>
</tr>
<tr>
<td>Purchase of property, plant and equipment (W5)</td>
<td>(3,255)</td>
</tr>
<tr>
<td>Proceeds from sale of plant</td>
<td>1,500</td>
</tr>
<tr>
<td>Dividends from investment (600 – 135)</td>
<td>465</td>
</tr>
<tr>
<td>Dividends from associate (W6)</td>
<td>750</td>
</tr>
<tr>
<td>Dividends paid to non-controlling interest (W7)</td>
<td>(144)</td>
</tr>
<tr>
<td><strong>Net cash used in investing activities</strong></td>
<td>(390)</td>
</tr>
</tbody>
</table>
### Cash flows from financing activities

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue of ordinary share capital (W8)</td>
<td>7,359</td>
<td></td>
</tr>
<tr>
<td>Issue of loan notes (W9)</td>
<td>2,760</td>
<td></td>
</tr>
<tr>
<td>Capital payments under leases (W10)</td>
<td>(810)</td>
<td></td>
</tr>
<tr>
<td>Dividends paid (3,735 + 7,500 – 10,335)</td>
<td>(900)</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash from financing activities</strong></td>
<td>8,409</td>
<td></td>
</tr>
</tbody>
</table>

### Net increase in cash and cash equivalents

- Cash and cash equivalents at 1.1.X7: 5,460
- Cash and cash equivalents at 31.12.X7: 13,545
- **Net increase in cash and cash equivalents**: 8,085

### Workings

1. **Depreciation charges**

   **ACCUMULATED DEPRECIATION – PLANT AND EQUIPMENT**

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation on disposal</td>
<td>300</td>
<td>3,300</td>
</tr>
<tr>
<td>C/fwd</td>
<td>3,600</td>
<td></td>
</tr>
<tr>
<td><strong>:: Charge for year</strong></td>
<td></td>
<td>600</td>
</tr>
<tr>
<td><strong>Freehold buildings</strong></td>
<td>3,900</td>
<td>3,900</td>
</tr>
</tbody>
</table>

   Freehold buildings ($6,600,000 – $6,225,000) = $375,000
   Total charge: ($375,000 + $600,000) = $975,000

2. **Interest**

   **INTEREST PAYABLE**

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount</td>
<td>120</td>
<td>90</td>
</tr>
<tr>
<td>Accrued interest b/fwd</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>:: Interest paid</strong></td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Accrued interest c/fwd</td>
<td>120</td>
<td>450</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td>540</td>
<td>540</td>
</tr>
</tbody>
</table>

3. **Taxation**

   **INCOME TAX PAYABLE**

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>B/fwd – current tax</td>
<td></td>
<td>651</td>
</tr>
<tr>
<td>– deferred tax</td>
<td></td>
<td>39</td>
</tr>
<tr>
<td>P/L transfer</td>
<td></td>
<td>1,485</td>
</tr>
<tr>
<td>(1,173 + 312)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C/fwd – current tax</td>
<td>1,386</td>
<td></td>
</tr>
<tr>
<td>– deferred tax</td>
<td>90</td>
<td></td>
</tr>
<tr>
<td><strong>On acquisition</strong></td>
<td></td>
<td>51</td>
</tr>
<tr>
<td><strong>Cash outflow</strong></td>
<td>750</td>
<td>2,226</td>
</tr>
</tbody>
</table>

4. **Purchase of subsidiary**

<table>
<thead>
<tr>
<th>Description</th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received on acquisition</td>
<td>336</td>
</tr>
<tr>
<td>Less cash consideration</td>
<td>(42)</td>
</tr>
<tr>
<td>Cash inflow</td>
<td>294</td>
</tr>
</tbody>
</table>
5 **Purchase of property, plant and equipment; machinery**

**Machinery at cost**

<table>
<thead>
<tr>
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<th>$000</th>
<th>$000</th>
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</thead>
<tbody>
<tr>
<td>B/fwd</td>
<td>4,200</td>
<td></td>
</tr>
<tr>
<td>On acquisition</td>
<td>495</td>
<td>Disposal</td>
</tr>
<tr>
<td>Right-of-use assets</td>
<td>2,550</td>
<td></td>
</tr>
<tr>
<td>.: Cash additions</td>
<td>3,255</td>
<td>C/fwd</td>
</tr>
<tr>
<td></td>
<td>10,500</td>
<td>10,500</td>
</tr>
</tbody>
</table>

6 **Dividends from associate**

**Investment in associate**

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>B/fwd</td>
<td>3,000</td>
<td>.: Dividends received</td>
</tr>
<tr>
<td>Share of profit after tax</td>
<td>1,050</td>
<td>C/fwd</td>
</tr>
<tr>
<td></td>
<td>4,050</td>
<td>4,050</td>
</tr>
</tbody>
</table>

7 **Non-controlling interest**

**Non-controlling interest**

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>.: Dividend paid</td>
<td>144</td>
<td>B/fwd</td>
</tr>
<tr>
<td>C/fwd</td>
<td>345</td>
<td>Profit for year</td>
</tr>
<tr>
<td></td>
<td>489</td>
<td>On acquisition</td>
</tr>
<tr>
<td></td>
<td>489</td>
<td>489</td>
</tr>
</tbody>
</table>

8 **Issue of ordinary share capital**

**Share capital**

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>B/fwd</td>
<td>12,285</td>
<td></td>
</tr>
<tr>
<td>Non-cash consideration</td>
<td>825</td>
<td></td>
</tr>
<tr>
<td>C/fwd</td>
<td>20,469</td>
<td>.: Cash inflow</td>
</tr>
<tr>
<td></td>
<td>20,469</td>
<td>20,469</td>
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</tbody>
</table>

9 **Issue of loan notes**

**Loan notes**

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>B/fwd</td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>Finance cost</td>
<td>120</td>
<td></td>
</tr>
<tr>
<td>C/fwd</td>
<td>4,380</td>
<td>.: Cash inflow</td>
</tr>
<tr>
<td></td>
<td>4,380</td>
<td>4,380</td>
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</tbody>
</table>
10 Capital payments under leases

LEASES

<table>
<thead>
<tr>
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<th>$'000</th>
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<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B/fwd</td>
<td>Current</td>
<td></td>
</tr>
<tr>
<td>.: Cash outflow</td>
<td>810</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>C/fwd</td>
<td></td>
<td>Long-term</td>
<td>510</td>
</tr>
<tr>
<td>Current</td>
<td>720</td>
<td>New lease liability</td>
<td>2,550</td>
</tr>
<tr>
<td>Long-term</td>
<td>2,130</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3,660</td>
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<td>3,660</td>
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</table>

30.3 Consolidated cash flow 2

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X2

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
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</thead>
<tbody>
<tr>
<td>Cash flows from operating activities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit before taxation</td>
<td>666</td>
<td></td>
</tr>
<tr>
<td>Adjustments for:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>78</td>
<td></td>
</tr>
<tr>
<td>Share of profit of associates</td>
<td>(120)</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>–</td>
<td>624</td>
</tr>
<tr>
<td>Increase in receivables</td>
<td>(37)</td>
<td></td>
</tr>
<tr>
<td>Increase in inventories</td>
<td>(41)</td>
<td></td>
</tr>
<tr>
<td>Increase in payables</td>
<td>221</td>
<td></td>
</tr>
<tr>
<td>Cash generated from operations</td>
<td>767</td>
<td></td>
</tr>
<tr>
<td>Interest paid</td>
<td>–</td>
<td></td>
</tr>
<tr>
<td>Income taxes paid (W5)</td>
<td>(160)</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash from operating activities</strong></td>
<td>607</td>
<td></td>
</tr>
<tr>
<td>Cash flows from investing activities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquisition of subsidiary Asiatic Ltd net of cash acquired (55 – 7)</td>
<td>(48)</td>
<td></td>
</tr>
<tr>
<td>Purchase of property, plant and equipment (W1)</td>
<td>(463)</td>
<td></td>
</tr>
<tr>
<td>Dividends received from associates (W3)</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash used in investing activities</strong></td>
<td>(411)</td>
<td></td>
</tr>
<tr>
<td>Cash flows from financing activities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends paid</td>
<td>(63)</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash used in financing activities</strong></td>
<td>(63)</td>
<td></td>
</tr>
<tr>
<td><strong>Net increase in cash and cash equivalents</strong></td>
<td>133</td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents at beginning of year (77 – 343)</td>
<td>(266)</td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents at end of year (43 – 176)</td>
<td>(133)</td>
<td></td>
</tr>
</tbody>
</table>

Workings

1 Purchase of property, plant and equipment

PROPERTY, PLANT AND EQUIPMENT

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B/fwd</td>
<td>Depreciation</td>
<td></td>
</tr>
<tr>
<td>Acquisition of Asiatic Ltd</td>
<td>694</td>
<td>78</td>
<td></td>
</tr>
<tr>
<td>.: Cash additions</td>
<td>463</td>
<td>4,764</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4,842</td>
<td></td>
<td>4,842</td>
</tr>
</tbody>
</table>
2 **Goodwill**

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GOODWILL</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B/fwd</td>
<td>–</td>
<td></td>
</tr>
<tr>
<td>Acquisition of Asiatic Ltd</td>
<td>42</td>
<td>: Impairment losses</td>
</tr>
<tr>
<td>(1,086 – (1,044 × 100%))</td>
<td></td>
<td>C/fwd</td>
</tr>
<tr>
<td></td>
<td>42</td>
<td>42</td>
</tr>
</tbody>
</table>

3 **Dividends received from associates**

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>INVESTMENT IN ASSOCIATE</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B/fwd</td>
<td>2,175</td>
<td></td>
</tr>
<tr>
<td>Share of profit</td>
<td>120</td>
<td>: Dividends received</td>
</tr>
<tr>
<td></td>
<td></td>
<td>C/fwd</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2,295</td>
<td></td>
</tr>
</tbody>
</table>

4 **Reconciliation of share capital**

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital B/twd</td>
<td>4,776</td>
</tr>
<tr>
<td>Issued to acquire sub (120,000 × $2.80)</td>
<td>336</td>
</tr>
<tr>
<td>Share capital C/fwd</td>
<td>5,112</td>
</tr>
</tbody>
</table>

: no shares have been issued for cash during the year.

5 **Income taxes paid**

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>INCOME TAX PAYABLE</strong></td>
<td></td>
</tr>
<tr>
<td>B/fwd – current tax</td>
<td>200</td>
</tr>
<tr>
<td>– deferred tax</td>
<td>180</td>
</tr>
<tr>
<td>: Cash paid</td>
<td>160</td>
</tr>
<tr>
<td>P/L</td>
<td>126</td>
</tr>
<tr>
<td>C/fwd – current tax</td>
<td>235</td>
</tr>
<tr>
<td>– deferred tax</td>
<td>111</td>
</tr>
<tr>
<td>: deferred tax</td>
<td>111</td>
</tr>
<tr>
<td></td>
<td>506</td>
</tr>
</tbody>
</table>

4 **Reconciliation of loan balance**

<table>
<thead>
<tr>
<th></th>
<th>$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan balance b/fwd</td>
<td>653</td>
</tr>
<tr>
<td>Issued to acquire sub</td>
<td>695</td>
</tr>
<tr>
<td>Loan balance c/fwd</td>
<td>1,348</td>
</tr>
</tbody>
</table>

: no loans have been issued for cash during the year.
ABBREVIATIONS APPENDIX
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full word, name or phrase</th>
</tr>
</thead>
<tbody>
<tr>
<td>AC</td>
<td>Audit Committee</td>
</tr>
<tr>
<td>ACRA</td>
<td>Accounting and Corporate Regulatory Authority</td>
</tr>
<tr>
<td>AFS</td>
<td>Available for Sale (financial assets)</td>
</tr>
<tr>
<td>AGD</td>
<td>Attorney General's Department</td>
</tr>
<tr>
<td>AGM</td>
<td>Annual General Meeting</td>
</tr>
<tr>
<td>ASC</td>
<td>Accounting Standards Council</td>
</tr>
<tr>
<td>AWS</td>
<td>Annual Wage Supplement</td>
</tr>
<tr>
<td>B/d</td>
<td>Brought down</td>
</tr>
<tr>
<td>B/f or B/fwd</td>
<td>Brought forward</td>
</tr>
<tr>
<td>CAAS</td>
<td>Civil Aviation Authority of Singapore</td>
</tr>
<tr>
<td>CAS</td>
<td>Charities Accounting Standard</td>
</tr>
<tr>
<td>CCA</td>
<td>Current Cost Accounting</td>
</tr>
<tr>
<td>CPF</td>
<td>Central Provident Fund</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>CFO</td>
<td>Chief Financial Officer</td>
</tr>
<tr>
<td>C/d</td>
<td>Carried down</td>
</tr>
<tr>
<td>C/f or c/fwd</td>
<td>Carried forward</td>
</tr>
<tr>
<td>CGC</td>
<td>Corporate Governance Council</td>
</tr>
<tr>
<td>CGU</td>
<td>Cash-Generating Unit</td>
</tr>
<tr>
<td>CLG</td>
<td>Company Limited by Guarantee</td>
</tr>
<tr>
<td>COC</td>
<td>Commissioner of Charities</td>
</tr>
<tr>
<td>CORM</td>
<td>Chief Operating Decision Maker</td>
</tr>
<tr>
<td>COO</td>
<td>Chief Operating Officer</td>
</tr>
<tr>
<td>CPFB</td>
<td>Central Provident Fund Board</td>
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<tr>
<td>CY</td>
<td>Current Year</td>
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<td>Exposure Draft</td>
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<td>Extraordinary General Meeting</td>
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<td>EPS</td>
<td>Earnings per Share</td>
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<td>EU</td>
<td>European Union</td>
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<td>EV</td>
<td>Economic Value</td>
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<td>US Financial Accounting Standards Board</td>
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<tr>
<td>FIFO</td>
<td>First-In-First-Out</td>
</tr>
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<td>FRS</td>
<td>Singapore Financial Reporting Standards</td>
</tr>
<tr>
<td>FV</td>
<td>Fair Value</td>
</tr>
<tr>
<td>FVTPL</td>
<td>Fair Value Through Profit or Loss</td>
</tr>
<tr>
<td>FVTOCI</td>
<td>Fair Value Through Other Comprehensive Income</td>
</tr>
<tr>
<td>GAAP</td>
<td>Generally Accepted Accounting Practice</td>
</tr>
<tr>
<td>Abbreviation</td>
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<tr>
<td>--------------</td>
<td>--------------------------</td>
</tr>
<tr>
<td>GEC</td>
<td>Governance Evaluation Checklist</td>
</tr>
<tr>
<td>GRI</td>
<td>Global Reporting Initiative</td>
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<td>Goods and Services Tax</td>
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<td>HTM</td>
<td>Held-to-Maturity Investments</td>
</tr>
<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>IE</td>
<td>Illustrative Examples</td>
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<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<td>Implementation Guidance</td>
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<td>IIRC</td>
<td>International Integrated Reporting Council</td>
</tr>
<tr>
<td>IP</td>
<td>Investment Property</td>
</tr>
<tr>
<td>IPC</td>
<td>Institution of a Public Character</td>
</tr>
<tr>
<td>IR</td>
<td>Integrated Reporting</td>
</tr>
<tr>
<td>IRAS</td>
<td>Inland Revenue Authority of Singapore</td>
</tr>
<tr>
<td>INT FRIS</td>
<td>Interpretation of Financial Reporting Standards</td>
</tr>
<tr>
<td>IITE</td>
<td>Institute of Technical Education</td>
</tr>
<tr>
<td>JV</td>
<td>Joint Venture</td>
</tr>
<tr>
<td>KPI</td>
<td>Key Performance Indicator</td>
</tr>
<tr>
<td>MAS</td>
<td>Monetary Authority of Singapore</td>
</tr>
<tr>
<td>NCI</td>
<td>Non-Controlling Interest</td>
</tr>
<tr>
<td>NRV</td>
<td>Net Realisable Value</td>
</tr>
<tr>
<td>OCI</td>
<td>Other Comprehensive Income</td>
</tr>
<tr>
<td>PPE</td>
<td>Property, Plant and Equipment</td>
</tr>
<tr>
<td>PUP</td>
<td>Provision for Unrealised Profit</td>
</tr>
<tr>
<td>PV</td>
<td>Present Value</td>
</tr>
<tr>
<td>RAP</td>
<td>Statement of Recommended Accounting Practice</td>
</tr>
<tr>
<td>ROS</td>
<td>Society Under the Registration of Charities</td>
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<tr>
<td>SB-FRS</td>
<td>Statutory Board Financial Reporting Standards</td>
</tr>
<tr>
<td>SE</td>
<td>Small Entity</td>
</tr>
<tr>
<td>SE for SE</td>
<td>Singapore Financial Reporting Standards for Small Entities</td>
</tr>
<tr>
<td>SFRS(I)</td>
<td>IFRS-identical financial reporting standards</td>
</tr>
<tr>
<td>SFRS(I) INT</td>
<td>IFRS-identical financial reporting interpretations</td>
</tr>
<tr>
<td>SGX</td>
<td>Singapore Exchange</td>
</tr>
<tr>
<td>SIM</td>
<td>Singapore Institute of Management</td>
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<td>SMEs</td>
<td>Small and Medium Entities</td>
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<td>Statement of Changes in Equity</td>
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<td>SOFA</td>
<td>Statement of Financial Activities</td>
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<tr>
<td>SOFP</td>
<td>Statement of Financial Position</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Full word, name or phrase</td>
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<tr>
<td>SPL</td>
<td>Statement of Profit or Loss</td>
</tr>
<tr>
<td>SPLOCI</td>
<td>Statement of Profit or Loss and Other Comprehensive Income</td>
</tr>
<tr>
<td>SRS</td>
<td>Supplementary Retirement Scheme</td>
</tr>
<tr>
<td>TCO</td>
<td>Total Comprehensive Income</td>
</tr>
<tr>
<td>TERP</td>
<td>Theoretical Ex-Rights Price</td>
</tr>
<tr>
<td>TWDV</td>
<td>Tax Written Down Value</td>
</tr>
<tr>
<td>YTD</td>
<td>Year to Date</td>
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ADDITIONAL REFERENCES AND DIRECT RESOURCES
We set out below a list of additional resources which you may find useful while studying this Module.

**General**

www.asc.gov.sg  
https://isca.org.sg  

**Chapter 1**

www.irpas.com  
http://investor.capitaland.com/investor_relations_policy.html  
http://corporate.marksandspencer.com/investors/shareholder-information/agm-information/agm-questions-and-answers  
www.straitstimes.com/business/new-online-calendar-spreads-out-agm-dates-this-month  
www.globalreporting.org/standards/gri-standards-download-center/  
www.csr singapore.org/c/resources/publications  
http://rulebook.sgx.com/en/display/display_main.html?rbid=3271&element_id=5626&print=1  
https://www.wsj.com/articles/SB110927160099363307  
http://uk.reuters.com/article/2013/01/19/us-caterpillar-siwei-idUSBRE90H1C520130119  
www.japantimes.co.jp/news/2015/09/18/business/corporate-business/pressure-to-show-a-profit-led-to-toshibas-accounting-scandal/#.VsHFuse5DHg  
http://integratedreporting.org/the-iirc-2/

**Chapter 2**

https://www.acra.gov.sg/legislation/  
www.asc.gov.sg  
www.ifrs.org  
https://www.ifrs.org/about-us/how-we-set-standards/  
Additional references and direct resources

www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx
www.ifrs.org/Current-Projects/IASB-Projects/Pages/IASB-Work-Plan.aspx

Chapter 3

Chapter 4
www.charities.gov.sg
www.assb.gov.sg/fr-assb_process.html

Chapter 5
http://isca.org.sg/ethics/
http://news.bbc.co.uk/2/hi/business/1780075.stm

Chapter 6

Chapter 7

Chapter 8
http://investor.capitaland.com/newsroom/20180406_070046_C31_YYVJWN4SCFO7W800.1.PDF

Chapter 12

Chapter 13
Chapter 14

Chapter 15

Chapter 16

Chapter 17
www.asc.gov.sg/Portals/0/attachments/Consultations/2014/Revenue_Article.pdf

Chapter 18
http://investor.capitaland.com/newsroom/20180406_070046_C31_YVJWN4SCF07W800.1.PDF

Chapter 19

Chapter 20

Chapter 21
http://sin-mi.listedcompany.com/misc/ar2017/index.html#46

Chapter 22
http://rulebook.sgx.com/en/display/display.html?rbid=3271&element_id=3356&print=1
www.iras.gov.sg/irashome/Schemes/Businesses/Productivity-and-Innovation-Credit-Scheme/
www.iras.gov.sg/irashome/WCS.aspx

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