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HANDOUTS

IAS-IFRS DEFINITIONS AND REQUIREMENTS (CORPORATE FINANCIAL REPORTING)

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It is a useful tool for studying the subject, but it does not guarantee preparation that is as exhaustive and complete for passing the exam as the material recommended by the University.

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IAS – IFRS DEFINITIONS AND REQUIREMENTS

GENERALLY ACCEPTED ACCOUNTING PRACTICE

Refers to the complete set of regulations (from all sources) which apply within a certain jurisdiction, together with any general accounting principals or conventions which are usually applied in that jurisdiction, even though may not be enshrined in regulations.

- Big GAAP: refers to the accounting regulations which apply to large companies (generally listed)
- Little GAAP: refers to simpler accounting regulations which apply to smaller companies.

PURPOSE OF ACCOUNTING STANDARDS

The main purpose of accounting standards is to reduce or eliminate variations in accounting practice and to introduce a degree of uniformity into financial reporting. Accounting standards usually set out requirements with regard to the recognition, measurement, presentation and disclosure of transactions and other items in financial statements.

- Faithful representation: accounting standards help to ensure that financial reporting is free from bias and that creative accounting practices are outlawed.
- **Comparability:** users should be able to compare the financial statements of an organisation over time so as to identify trends in its financial performance and position. Users should be able to compare the financial statements of different organisations and assess their relative strengths and weaknesses.

The IASB conceptual framework

CONCEPTUAL FRAMEWORK PURPOSE OF GENERAL-PURPOSE FINANCIAL REPORTING

To provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decision related to providing resources to the entity.

If there is any conflict between the conceptual framework and an international standard, then the standard prevails. General purpose financial reports are not designed to show the value of the reporting entity but may help primary users to estimate the entity's value.

ACCRUAL ACCOUNTING

Transactions and other events are recognised in the periods in which they occur (not necessary when cash is received or paid).

MATERIALITY

Is mainly concerned with the size or monetary amount of an item and information is said to be material if omitting, misstating, or obscuring it could influence users' decisions.

Qualitative characteristics of useful financial information:

- Fundamental:
 - **Relevance:** relevant to users decision-making needs:
 - *Predictive value* - helps users to predict future outcomes.
 - *Confirmatory value* - provides feedback which helps to confirm or refute previous predictions.
 - **Faithful representation:**
 - *Completeness:* includes all the information required in order that a user should understand the transactions and other events
 - *Neutrality:* information is unbiased (prudence*)
 - *Freedom from error:* there are no errors or omissions in the description of the items being represented and no errors have been made when selecting and applying the process used to produce the information.



- Enhancing:
 - **Comparability**
 - **Verifiability:** if independent, knowledgeable observers are able to agree that the information concerned gives a faithful representation
 - **Timeliness:** information is made available to users in time for it to be capable of influencing their economic decisions
 - **Understandability:** should be understandable by users

PRUDENCE: *The exercise of due caution when making judgments under condition of uncertainty*

OBJECTIVE OF FINANCIAL STATEMENTS

To provide financial information about the reporting entities assets, liabilities, equity, income, and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of entities economic resources.

ASSET

Present economic resource controlled by the entity as a result of past events. An economic resource is a right that has a potential to produce economic benefits.

LIABILITY

Present obligation of the entity to transfer an economic resource as a result of past events. A present obligation is one that the entity cannot practically avoid.

There is no requirement for an item to be legally owned by the entity concerned in order that it should qualify as an asset, merely that it should be controlled by the entity. This means that certain leased items may be classified as assets. An obligation cannot be classed as a liability unless it has the potential of requiring the entity to transfer economic resources through another party.

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

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.*

RECOGNITION: *Is the process of capturing for inclusion in the statement of financial position or the statements of financial performance an item that meets the definition of one of the elements of financial statements.*

DE-RECOGNITION: *Is the removal of all or part of a recognised asset or liability from an entity's statement of financial position.*

Measurement of the elements:

- **Historical costs:** assets are measured at the amounts paid to acquire them. Liabilities are measured at the amount of the consideration received in exchange for taking on the obligation concerned.
- **Current value:** measures assets and liabilities using information which has been updated to reflect conditions at the measurement date:
 - *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.
 - *Value in use:* the present value of the net cash flows that the entity expects to derive from the use of the asset and from its eventual disposal.
 - *Current cost:* the amount that would have to be paid to acquire an equivalent asset at the measurement date.



IAS 1 – Presentation of Financial Statements

IAS1 applies to all general-purpose financial statements prepared and presented in accordance with international standards. General purpose financial statements are those intended for users who are not in a position to demand reports that are tailored for their own particular information needs.

IAS1 states that a complete set of financial statement comprises:

- A statement of financial position as at the end of the accounting 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
- A set of notes, together with other explanatory information
- Comparative information in respect of the previous period
- A statement of financial position as at the beginning of the previous period, in the case that the entity has applied an accounting policy retrospectively or has made a retrospective restatement.

IAS1 requires that each material class of similar items should be presented separately in the financial statements. It takes the view that offsetting should not be allowed, since this would normally detract from users' ability to understand transactions and other events.

CURRENT AND NON-CURRENT ASSETS: An asset is classified as a current asset if it satisfies any of the following criteria:

- It is expected to be realised, or is intended for sale or consumption, within the entities normal operating cycle.
- It is held primarily for the purpose of being traded.
- It is expected to be realised within 12 months after the reporting period.
- It is cash or cash equivalent as defined by the standard IAS7 unless it is restricted from being exchanged or from being used to settle a liability for at least 12 months after the reporting period.

An asset which satisfies none of this criterion is a non-current asset. The operating cycle of an entity is defined as the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. If an entity is operating cycle cannot be clearly identified, it is assumed to be 12 months.

CURRENT AND NON-CURRENT LIABILITIES: A liability is classified as a current liability if it satisfies any of the following criteria:

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

A liability that satisfies none of this criterion is a noncurrent liability.

An important further requirement of IAS1 is that an entity should not present any items of income or expense as extraordinary items, either in the statements of comprehensive income or in the notes.

IAS1 requires that and entities other comprehensive income should be presented in two categories:

- items of other comprehensive income which, if certain conditions are satisfied, will be reclassified to profit or loss in a subsequent reporting period.
- Items of other comprehensive income which will not be reclassified to profit or loss.

The entity must also present an analysis of expenses using a classification based on either:

- the nature of expenses (might include headings such as depreciation, employee benefits, motor expenses)
- the function of the expenses within the entity: (cost of sales, distribution costs, and administrative expenses)



IAS1 states that the notes should:

- present information about the basis of preparation of the financial statements and their accounting policies. The notes should disclose material accounting policy information which can reasonably be expected to influence the decisions that the primary users of general-purpose financial statements make on the basis of those financial statements.
- Disclose information required by international standards.
- Provide any additional information which is relevant to an understanding of any of the financial statements.

If there is a significant risk that uncertain future events could cause a material adjustment to the carrying amount of assets or liabilities within the next financial year, IAS1 requires that the notes to the financial statements should explain the key sources of estimation uncertainty and disclose the assumption that have been made.

IAS 34 – Interim Financial Reporting

INTERIM FINANCIAL REPORT: A financial report containing either a complete set of financial statements [...] or a set of condensed financial statements [...] for an interim period. An interim period is a period which is less than a full financial year.

Further information should be provided about matters such as seasonality of entities operations, the nature and the amount of any unusual items, the nature and the amount of any changes made to estimates from previous periods, any shares issues or repayment of debt securities, any dividends paid and any significant event after the interim period which were not reflected in the interim financial statements.

IFRS Practice Statement 1 (2010)

A management commentary is a narrative report which explains the amounts presented in an entity's financial statements and sets those statements in a context. It also provides an analysis of the entity's future prospects and may contain other information not presented in the financial statements.

IFRS Practice Statement 2 (2010)

The making of materiality judgments is pervasive in the preparation of financial statements. Such judgments are required when making decision relating to recognition, measurement, presentation, and disclosure. Furthermore, the requirements of international standards do not need to be applied to immaterial items. When making materiality judgments, an entity must consider the types of decisions which the primary users might make on the basis of their financial statements and the information needed in order to make those decisions.

IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors

IAS8 prescribes the circumstances in which an entity may change an accounting policy. It also deals with the accounting treatment and disclosure of changes in accounting policies, accounting estimates, and corrections of prior period errors. IAS1 requires entities to disclose material accounting policy information in the notes, which form a part of the financial statements. Guidance on the selection of accounting policies is given in IAS 8.

ACCOUNTING POLICIES: The specific principals, bases, conventions, rules, and practices applied by an entity in preparing and presenting financial statements.

IAS8 allows an entity to change one of its accounting policies only if the change:

- is required by an international standard or IFRIC interpretation, or
- results in the financial statements providing reliable and more relevant information.

Comparative figures for the previous period must be adjusted and presented as if the new accounting policy has always been applied. The opening balance of each effective component of equity must be adjusted. These adjustments take place in the statement of changes in equity.

ACCOUNTING ESTIMATES: Monetary amounts in financial statements that are subject to measurement uncertainty. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.



IAS 8 requires an entity which changes an accounting estimate to account for the change prospectively, not retrospectively. When it is difficult to distinguish a change in accounting policy from a change in accounting estimate, IAS8 requires that the change concerned should be treated as a change in an accounting estimate. IAS8 requires disclosure of the nature and amount of the change in accounting estimates which has an effect in the current period or is expected to have an effect in the future periods. However, this requirement is subject to the materiality rule.

PRIOR PERIOD ERRORS: 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:

- Was available when financial statements for that period were authorised for issue, and
- Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

IAS8 requires that material prior period errors should be corrected retrospectively.

IFRS 8 – Operating segments

IFRS8 requires an entity which falls within its scope to disclose information that will enable the users of the financial statements to evaluate the nature and financial effects of the business activities in which engages and the economic environment in which it operates.

OPERATING SEGMENT: An operating segment is a component of an entity:

- 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).
- Those financial results are regularly received by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance.
- For which discrete financial information is available.

IFRS8 requires an entity to provide the separate information about each of its reportable segments. This information is disclosed in the notes to the financial statements. The following rules are used to identify an entity's reportable segment:

- Two or more operating segments may be combined into one operating segment if the segment concerned have similar economic characteristics and are similar in each of the following respects:
 - the nature of the products or services involved.
 - the nature of the production processes
 - the type or class of customer for the products or services
 - the distribution methods used.
 - the nature of applicable regulatory environment
- A reportable segment is a single or a combined operating segment which meets any of the following quantitative thresholds:
 - it has reported total value from sales to external customers and sales to other operating segments is at least 10% of the total revenue of all operating segments.
 - its reported profit or loss is at least 10% of the combined profit of all operating segments that reported a profit or the combined loss of all the operating segments that reported a loss, whichever is greater.
 - its assets are at least 10% of the total assets of all operating segments.
- An operating segment that does not meet any of the 10% threshold may nonetheless be treated as a reportable segment if management believes that information about the segment would be useful to users' other financial statements. Alternatively:
 - such a segment may be combined into a reportable segment with one or more similar operating segments that also fail to meet any of the 10% thresholds.



- it may be included in an “all-other segments category” in the segment report.
- If the total external revenue attributable to reportable segments is less than 75% of the entity's total external revenue, additional operating segments must be identified as reportable, until at least 75% of total external revenue is included in reportable segments.

IAS 7 – Statement of Cash Flows

IAS7 requires that all entities which comply with international standards should produce a statement of cash flows. Its main objective is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing, and financing activities.

CASH: comprises cash on hand and demand deposits

CASH EQUIVALENTS: Short term, highly liquid investments which are readily convertible to known amounts of cash, and which are subject to an insignificant risk of changes in value. An investment will usually not qualify as a cash equivalent, unless it is a maturity date which is no more than three months after the date of acquisition. Equity investments are generally excluded from the definition, but redeemable preference shares with a specified redemption date in the near future might qualify.

OPERATING ACTIVITIES: The principal revenue-producing activities of the entity. Cash inflows and outflows arising from operating activities include:

- cash receipts from the sale of goods and services.
- cash receipts from royalties, fees, commissions, and other revenue.
- cash payments to suppliers for goods and services.
- cash payments to and on behalf of employees.
- cash payments or cash returns of income taxes unless specifically identified with investing or financing activities.

INVESTING ACTIVITIES : The acquisition and the disposal of long-term assets and other investments not included in cash equivalents. Cash inflows and outflows arising from investing activities include:

- cash payments to acquire property, plants and equipment, intangible assets, and other long-term assets.
- cash receipts from the sale of property, plant and equipment, intangible assets, and other long-term assets.
- cash payments to acquire equity or debt instruments of other entities.
- cash receipts from the sale of equity or debt instruments of other entities.
- cash advances and loans made to other parties.
- cash receipts from the repayment of advances and loans made to other parties.

FINANCING ACTIVITIES: Activities that result in changes in the size and composition of equity and borrowings of the entity. Cash inflows and outflows arising from financing activities include:

- cash proceeds from issuing shares.
- cash payments to owners to acquire or redeem the entities own shares.
- cash proceeds from issuing debt, loans, and other borrowings.
- cash repayments of amounts borrowed.
- cash payments made by the lessee for the reduction of the outstanding liability relating to the lease.

IAS 16 – Property, Plant and Equipment

Its aim is prescribing the accounting treatment of property, plant, and equipment (PPE). IAS16 does not apply to PPE which is classified as held for sale.

PROPERTY, PLANT AND EQUIPMENT - tangible items that:



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

CARRYING AMOUNT: the amount which an asset is recognised after deducting any accumulated depreciation and any accumulated impairment losses.

IAS16 states that an item of PPE should be recognised as an asset if and only if:

- it is probable that future economic benefits associated with the item will flow to the entity concerned, and
- the cost of the item can be measured reliably.

Items of PPE acquired for safety or environmental reasons are recognised as assets because they enable the entity to derive future economic benefits from its other PPE.

IAS16 requires that the cost of major replacements should be treated as capital expenditure and recognised as an addition to the carrying amount of the asset concerned. The carrying amount of the part that has been replaced should be similar to the carrying amount of the original part. Each item of PPE which has been recognised as an asset needs regular major inspections, the cost of each inspection is added to the carrying amount of the asset when it occurs. Any remaining carrying amount of the cost of a previous inspection is then recognised.

DERECOGNITION: an item of PPE previously recognised as an asset should be derecognised when:

- It is disposed of, or
- no future economic benefits are expected from its use or from its disposal.

IAS16 states that any gain or loss arising on the derecognition of an item of PPE, should be included in profit or loss. The gain or loss arising on Derecognition is equal to the difference between the disposal proceeds (if any) and the assets carrying amount at the time of the recognition.

IAS16 requires that items of PPE should be measured at cost. The cost of an item of PPE comprises:

- the purchase price of the item, including import duties and non-refundable purchase taxes, less trade discounts or rebates.
- Cost that are directly attributable to bringing the item to the location and condition necessary for it to be operated as intended, including:
 - labour costs arising directly from the construction or acquisition of the item.
 - site preparation costs
 - initial delivery and handling costs
 - installation, assembly, and testing costs
 - professional fees
- the estimated costs of dismantling and removing the item and restoring the site on which it is located, as long as the obligation to meet these costs is incurred when the item is acquired or used.

The cost of self-constructed asset is determined in the same way as the cost of any other item of PPE. If the entity sells similar assets to customers in the normal course of trade, the cost of the self-constructed asset will usually be the same as the cost of the constructing an asset for sale.

IAS16 allows two different methods of measuring PPE subsequent to its initial recognition:

- cost model: After initial recognition, items of PPE are carried at cost less any accumulated depreciation and less any accumulated impairment losses.
- Revaluation model: after initial recognition, items of PPE are carried at the revaluated amount. The revaluated amount of an item consists of its fair value at the date of revaluation, less any subsequent accumulated depreciation and less any subsequent accumulated impairment losses.



- The revaluation model cannot be applied to an item of PPE unless its fair value can be measured unreliably.
- either evaluation model is applied to an item of PPE then it must be applied to the entire class to which the item belongs. A class of PPE is a grouping of items of similar nature.

Is the carrying amount of an item of PPE is increased as a result of a revaluation, the increase must normally be credited to a revaluation reserve and shown as other comprehensive income in the entities statement of comprehensive income. Is the carrying amount of an item of property plant and equipment is decreased as a result of a revaluation, the decrease must normally be recognised as an expense when calculating the entity's profit or loss.

- A revaluation increase must be recognised as an income when calculating an entity's profit or loss to the extent that it reverses A revaluation decrease in respect of the same item that was previously recognised as an expense.
- Revaluation decrease must be debited to the revaluation reserve and shown in other comprehensive income to the extent of any credit balance previously existing in the revaluation reserve in respect of that same item.

When an item of PPE is disposed of, any revaluation gain which is included in the revaluation reserve in respect of that item maybe transfer the two retained earnings. This transfer takes account of the fact that a previously unrealized gain has now been realised. The transfer is recorded in the statement of changes in equity and does not affect the statement of comprehensive income.

DEPRECIATION: the systematic allocation of the depreciable amount of an asset over its useful life.

DEPRECIATABLE AMOUNT: the cost of an asset, or other amount substitute for cost, less its residual value.

RESIDUAL VALUE (OFF AN ASSET): The estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated cost of disposal, either where already of the age and in the condition expected at the end of its useful life.

USEFUL LIFE: 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.

If an item of PPE is revalued upwards and the revaluation gain in relation to that item is credited to revaluation reserve, subsequent depreciation charges will exceed depreciation based upon the item's original cost. In these circumstances, the amount of excess depreciation in each accounting. May be transferred from the revolution reserve 2 retained earnings.

Each part of an item of PPE with a cost that is significant in relation to the items total cost should be depreciated separately. However, parts of an item that may be grouped for depreciation purposes if they had the same useful life and yet the same depreciation method is applicable to each part.

If an item of PPE is used to produce other assets, when the depreciation of what item should be included in the cost of those other assets. For instance, the depreciation of factory machines may be included in the cost of inventories.

Residual value and the useful life of PPE should be reviewed at least at the end of each financial year. If expectations differ from previous estimates, Revised estimates should be accounted for prospectively, as required by IAS8.

Depreciation should begin when the asset is available for use and then continue until the asset is derecognized or classified as held for sale. Land and buildings should be dealt with separately from another for the appreciation purposes. In most cases, land is an unlimited useful life and so it is not depreciated for that reason.



But an exception arises in the case of quarries, mines, etc. which generally have finite useful lives and so should be depreciated.

Depreciation methods:

- *Straight line method*: the assets depreciable amount is spread evenly over its useful life, so giving a constant depreciation charge in each accounting.
- *Diminishing balance method*: the depreciation charges foreign accounting. Is calculated by applying a constant percentage to the carrying amount of the asset brought forward from the previous. This method gives a decreasing depreciation charge in each successive.
- *Units of production method*: the useful life of the asset is measured in units of production and the depreciation charge for an accounting. Is calculated in accordance with the number of units of production achieved in that.

The chosen method should be the one which is most closely matches the usage pattern of the asset concern. With appreciation method applied to an asset that should be reviewed at least at the end of each financial year and changed its various being add change in its usage pattern. Such a change should be accounted for as a change in accounting estimates (IAS8).

IAS 23 – Borrowing Costs

It is a is to prescribe the accounting treatment of interest and other borrowing costs, especially votes which are encouraged in connection with the acquisition of assets such as PPE. Its core principal is that borrowing costs are directly attributable choose an acquisition, construction or production of a qualifying asset, should be capitalised as part of the cost of the asset.

BORROWING COSTS - interest and other costs that an entity incurs in connection with the borrowing off funds:

- cost accounted for by the effective interest method
- interest arising in respect of lease liabilities.

QUALIFYING ASSET: an asset that necessarily take a substantial period of time to get ready for its intended use or sale. Depending on the circumstances, qualifying assets may be:

- inventories
- manufacturing plants and power generation facilities
- intangible assets
- investment properties.

Inventories without produced over a short period of time are not qualifying assets. Nor are assets which are ready for their intended use or sale as soon as they are acquired.

The borrowing costs that are directly attributable to the acquisition, construction or production of qualifying asset are those borrowing costs which would have been avoided if the expenditure on that asset had not occurred. If a qualifying asset is funded out of a pool of general borrowings, the borrowings costs which may be capitalised are calculated by applying A capitalization rate to the expenditure on the asset.

PERIOD OF CAPITALIZATION: the capitalization of borrowing costs incurred in relation to a qualifying asset should begin as soon as all of the following conditions are satisfied:

- expenditure is begun to be incurred on the asset.
- borrowing costs are being incurred.
- activities are in progress that are necessary to prepare the asset for its intended use.

An entity is required to disclose:

- the amount of borrowing costs capitalised during the accounting.



- The capitalization rate used to calculate the amount of general borrowings costs that are eligible for capitalization.

IAS40 – Investment Property

Its objective is to offer a more suitable accounting treatment for property held as an investment.

INVESTMENT PROPERTY: property (land or a building - or part of a building - or both) how 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
- for sale in the ordinary course of business.

Examples of investment property include the following:

- land held for long term capital appreciation.
- land held for currently undetermined future use
- a building that is leased out under one or more operating leases
- a building that is vacant but is held to be leased out under operating leases.
- property that is being constructed or developed for future use as investment property.

Investment properties should be measured initially at cost. This includes transaction costs such as legal fees and property transfer taxes. As regards the measurement of investment properties subsequent to its initial recognition, IAS40 requires an entity to choose between:

- the fair value
- the cost model: the basis for conclusions for IAS40 suggests that which model might be used in countries with less developed property markets and valuation professions.

IFRS 13 – Fair Value Measurement

Its objectives are to define fair value, to set out framework for measuring their value, and to specify the required disclosures about fair value measurements.

FAIR VALUE: the price that would be received to sell an asset or paid to transfer liability in an orderly transaction between market participants at the measurement date.

Fair values of assets and liabilities should be determined by using appropriate valuation techniques:

- the market approach uses prices generated by market transactions involving identical or compatible assets.
- the cost approach, which is based upon the current replacement costs.
- the income approach, which converts future amounts into a single current discounted amount.

IFRS13 also establishes a fair value hierarchy:

- *Level 1* inputs are quoted prices in active markets for identical assets or liabilities.
- *Level 2* inputs are inputs that are observable for the asset or liability, either directly or indirectly
- *Level 3* inputs are unobservable inputs for the asset or liability. Such inputs use the best information available about the assumption that market participants would make when pricing the asset or liability.

Entities must disclose information that helps the users of financial statements to assess the valuation techniques and inputs used to determine their value measurements. The effect on profit or loss of any measurement using Level 3 inputs must also be disclosed.

IAS 38 – Intangible Assets

Applies to all intangible assets except for those which fall within the scope of and other international standard.

INTANGIBLE ASSET: an identifiable, non-monetary asset without physical substance.



- **ASSET** is defined as 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:
 - future economic benefits: there must be an expectation of future economic benefits, such as revenue from the sale of goods and services or cost savings.
 - Control: the entity must have the power to obtain future economic benefits flowing from the resource.
- Without physical substance
- NON-MONETARY: monetary assets are defined as money held and assets to be received in fixed or a determinable amount of money.
- IDENTIFIABLE: an asset is identifiable when it arises from contractual or other legal rights or when it is separable. An asset is separable if it is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged.

An item should be recognised as intangible asset if it meets with definition given above and satisfies the following recognition criteria:

- it is probable that the expected future economic benefits which are attributable to the asset will flow to the entity.
- the cost of the asset can be measured reliably.

IAS38 states that intangible assets should be measured initially at their cost. The cost of an intangible asset is the cost in quart to acquire it or internally generate it.

Internally generated intangible assets are those which have been developed by the entity itself rather than purchased from another entity. To resolve these problems, IAS38 states that internal generation of an incredible asset should be classified into a research phase or a development phase.

RESEARCH PHASE: original and planned investigation undertaking with very respect of gaining new specific or technical knowledge and understanding.

IAS38 takes the view that, in the research phase of an internal project, it is not possible to demonstrate that an asset exists which will be probably generate future economic benefits. In consequence, entities are not allowed to recognise an intangible asset arising from research work. All research expenditure must be written off as an expense when it is incurred.

DEVELOPMENT PHASE: the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems, or services before the start of the commercial production or use.

IAS38 requires that an intangible asset arising from the development phase of an internal project must be recognised if all of the following can be demonstrated:

- the technical feasibility of completing the asset that will be ready for use or sale.
- the entity's intention to complete the asset and use or sell it.
- the entity's ability to use or sell the asset.
- the fact that the asset will probably generate future economic benefits.
- the availability of adequate technical, financial, and other resources to complete the development work and use or sell the asset.
- the entity's ability to measure reliably the expenditure attributable to the asset during its development.

If any of these cannot be demonstrated, the development expenditure concerned must be written off as an expense when it is incurred.



The cost of an internally generated intangible asset is the sum of the directly attributable costs in connection with the asset from the date when it first meets the recognition criteria listed above. Examples of directly attributable costs include:

- cost of materials and services used or consumed in generating the asset.
- labour costs arising from the generation of the assets.
- fees to register legal rights.
- amortisation of patents and licences used to generate the asset.

IAS 38 provides a number of examples of expenditure on intangible resources that must be recognised as an expense when the expenditure is incurred:

- start-up costs
- training expenditure
- expenditure on advertising and promotional activities
- expenditure on relocating or reorganising part of all of the entity.

If the carrying amount of an intangible asset is increased as a result of a revaluation, the increase must normally be credited to a revaluation reserve and recognised as other comprehensive income in the statement of comprehensive income. This treatment ensures that unrealised revaluation gains are excluded from profits and so are not available for payments as dividends. If the carrying amount of an intangible asset is decreased as a result of a revaluation, the decrease must normally be recognised as an expense when calculating the entity's profit or loss.

When an intangible asset is disposed of, any revaluation gain included in the revaluation reserve in respect of that asset might be transferred to retained earnings.

Intangible assets with finite useful lives are amortised. Intangible assets with indefinite useful life or not.

If an intangible asset arises from contractual or other legal rights, the useful life of the asset cannot exceed the period of force of those rights but may be shorter than this if the entity intends to use the asset for a shorter period. An intangible asset should be regarded as having an indefinite useful life only if there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

Amortisation of an intangible asset should begin when the asset is available for use and should then continue until the asset is derecognised or classified as held for sale. If the asset's usage pattern cannot be estimated reliably, then the straight-line method should be used.

The residual value of an intangible asset with a finite useful life is normally assumed to be 0. A residual value will not be the case if:

- a third party is committed to buy the asset at the end of the useful life.
- residual value can be determined by reference to an active market for the type of asset concerned, and such market will probably still exist at the end of the asset's useful life.

The residual value of an intangible asset should be reviewed at least at the end of each financial year. The useful lives of each intangible asset and the amortisation method that is used for that asset should be reviewed at least at the end of each financial year. If the asset's expected useful life has changed, the amortisation should be changed accordingly.

An item previously recognised as an intangible asset should be derecognised when:

- it is disposed of
- no future economic benefits are expected from its use or from its disposal.



IAS38 states that any gain or loss which arises on the day recognition of an intangible asset should be recognised in profit or loss when the asset is recognised. The gain or loss arising on TV cognition is equal to the difference between the disposal proceeds (if any) and the assets carrying amount at the time of the recognition.

IFRS3 - Business Combinations

BUSINESS COMBINATION: at transaction or other event in which an acquirer obtains the control of one or more Businesses.

If an intangible asset is acquired as a part of a business combination, the cost of the asset is specified by IAS38 to be the assets for value on the date of acquisition.

A business combination occurs when an entity acquires control of a business. This may happen when:

- the acquirer by net assets which together form a business.
- the acquirer buys the shares of another entity and so establishes apparent-subsidary relationship.

GOODWILL: an asset representing the future economic benefits arising from assets acquired in a business combination that are not individually identified and separately recognised.

The amount of goodwill to be recognised is the excess of:

- the price paid by the acquirer in the business combination, over.
- the acquirers interest in the net fair value of the acquirere's identifiable assets and the liabilities at the acquisition date.

Easter surprise paid by the acquirer in a business combination is less than the net fair value of the identifiable assets and liabilities acquired, the ferry is at negative goodwill. This situation could arise from 2 main reasons:

- errors might have been made when de terminating the third value of the consideration or the fair values of identifiable assets and liabilities acquired.
- the acquirer may have made a bargain purchase.

Any negative goodwill which remains after this reassessment should be treated as income and included in the acquirers profit or loss.

After initial recognition, goodwill acquired in a business combination should not be amortised. IFRS3 requires that such goodwill Should be measured at the amount initially recognised less any accumulated impairment losses.

IFRS10 – Consolidated Financial Statements

CONSOLIDATED FINANCIAL STATEMENTS: financial statements of a group in which the assets, liabilities, equity, income, expenses and the cash flows of the parent company and its subsidiaries are presented as those of a single economic entity. Consolidated financial statements are often referred to as *group accounts*.

GROUP: a parent and its subsidiaries

PARENT: an entity that controls one or more entities

SUBSIDIARY: an entity that is controlled by an over entity.

IFRS10 requires that parent companies should prepare and present consolidated financial statements. A parent does not need to present consolidated financial statements if all of the following conditions are satisfied.

- The parent company is itself either:
 - A wholly owned subsidiary



- A partially owned subsidiary of another company, and all of its other owners do not object to the parent not presenting consolidated financial statements.
- The parents shares or securities are not publicly traded.
- The parents ultimate parent company presents consolidated financial statements which are available for public use and comply with international standards.

A parent company which satisfies these conditions may present its own separate financial statements, only in accordance with IAS27.

IFRS10 states that an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and as the ability to affect those returns through its power over the investee. The standard also states that an investor has power over an investee when the investor has existing rights that enable it to direct the relevant activities:

- The sale and purchase of goods and services
- The selection, acquisition, or disposal of assets
- The management of financial assets
- Research development
- The determination of funding structure for the entity and the obtaining of funding.

An investor does not have the power over an investee unless the investor as rights that enable it to direct the investors relevant activities. Rights which may give this power include:

- Voting rights
- The right to appoint or remove a member of the investee's key management personnel.
- The right to direct the investee to enter into transactions for the investor's benefits.

Control is normally assumed to exist when one company owns (directly or indirectly) more than 50% of the voting power of another company unless it can be demonstrated that such ownership does not give control.

If a parent company owns 100% of the shares of capital of the subsidiary, the cost of the parent's investment in that subsidiary should be cancelled out with the subsidiaries share capital and reserves. This is because the purchase of 100% of a company's share capital also buys entitlement to 100% of that companies reserves.

If one group company owes money to another, the amount payable which is shown as a liability in the financial statement of the first company should be cancelled out with the corresponding amount receivable which is shown as an asset in the financial statements of the other company. Such debts are known as *intra-group balances*.

IFRS3 prescribes the accounting treatment of any goodwill acquired in a business combination. This includes the situation where the parent acquires control of a subsidiary.

Each of the subsidiaries' assets and liabilities is adjusted to its fair value on the date that the parent company acquired the business share. Gains and losses caused by these adjustments are added or subtracted from the subsidiary's reserves.

If the parent has paid more than the fair value to acquire the shares of the subsidiary, the excess is goodwill arising on consolidation and this is shown as an asset in the consolidated statement of financial position. Goodwill should be tested annually for impairment and written down, as necessary. If the parent has paid less than fair value to acquire the shares of a subsidiary, then negative goodwill appears to have arisen. In this situation the standards requires that the cost of investment made by the parent and the fair values of the subsidiaries assets and liabilities should be reassessed. Any negative goodwill which remains after this reassessment is recognised as income and increases the group's reserves.



Any after-acquisition increase in the retained earnings of a subsidiary represents an increase in the value of the investment made by the parent company. This increase in value belongs ultimately to the shareholders of the parent company and should therefore be added to group retained earnings. Any post acquisition decreases in the retained earnings of a subsidiary should be subtracted from group retained earnings. Any after-acquisition changes in any of their subsidiary's reserves are dealt with the same way. An impairment loss in relation to goodwill is accounted for by reducing both the goodwill figure and the group retained earnings by the amount of the loss.

If the parent company does not own 100% of a subsidiary's share capital, the subsidiary is partially owned and the remainder of its shares are held by non controlling shareholders. IFRS10 prescribes that the group statement of financial position should include all of the subsidiary assets and all of its subsidiary liabilities but should identify separately the amount of the subsidiary's net assets which is attributable to the non controlling shareholders (non controlling interests). Noncontrolling interest should be presented in the equity section of the group statement of financial position but separated from the equity of the parent company's shareholders.

IFRS3 allows parent companies to measure non controlling interests in either of two ways:

- Non-controlling interest may be measured by calculating the non controlling shareholders portion of the subsidiaries identifiable net assets. Identifiable assets do not include goodwill; this means that any goodwill which belongs to the non controlling shareholders is not included in the non-controlling interests.
- On acquisition, non-controlling interests may be measured at fair value. Any excess of this fair value over the non controlling shareholders proportion of the subsidiaries identifiable net assets on the acquisition date is recognised as goodwill in the group statement of financial position. This approach has two main consequences:
 - The goodwill figure shown in the group's statement of financial position on the date of acquisition will be equal to 100% of the subsidiary's goodwill.
 - Any goodwill impairment losses which occur after acquisition are deducted partly from group reserves and partly from the non-controlling interests.

Intragroup balances are cancelled out when preparing the consolidated statement of financial position. Such balances may arise in any of the following circumstances:

- One group company may lend money to another group company. In this case, the loan will appear as an asset in the lending company's financial statements and as a liability in the borrowing company financial statements.
- One group company may buy items on credit from another group company, so that there is a trade receivable in the financial statements of the supplier company and a trade payable in financial statements of the customer company.
- Our current account may be used to record movements of goods, services, and money between two group companies. The balance on this account will be an asset for one of the companies and the liability for the other company. If items are in transit from one company to another, it may be that the relevant asset and liability are not equal in amount. In this case it will be necessary to show the in-transit items as an asset in the consolidated statement of financial position.

The assets showing the individual financial statements of the group company may include assets acquired from another company in the group. If such assets have been transferred between the two companies at a price in excess of their original cost, then their valuation includes an element of unrealized profit, and this must be eliminated when the consolidated statement of financial position is prepared.

IFRS10 requires that all profits or losses on intra group transactions must be eliminated in full on consolidation. If an asset is sold from parent to subsidiary, any unrealized profit on the transaction is entirely attributable to the group and is subtracted from group retained earnings. If an asset is sold from subsidiary to parent, any unrealized



profit on the transaction is allocated proportionally between group retained earnings and the non-controlling interest, if any.

If the reporting period of a parent is different from that of a subsidiary, the subsidiary should prepare additional financial statements for consolidation purposes, using the same reporting period as its parent. However, if this is not practical, the parent should consolidate the subsidiary's most recent financial statements, adjusted to reflect any significant transaction or event occurring between the date of those financial statements and the date of the consolidated financial statements. IFRS10 requires that the difference between the end of the reporting period of a subsidiary and that of its parent should not exceed 3 months. If a group company uses different accounting policies from both adopted in the consolidated financial statements, its own financial statements should be adjusted in line with the group's accounting policies before the consolidation takes place.

The main purpose of a group statement of comprehensive income is to report the profit or loss of the group as a whole. IFRS10 states that such a statement should be prepared and presented in recognition of the fact that a parent company and its subsidiaries are in effect a single economic entity.

- Intra group sales are deducted from group's sales revenue and from group's cost of sales when preparing the group statement of comprehensive income. This ensures that the group financial statements show only sales to external customers and the cost of goods acquired from external suppliers.
- Any unrealized profit on inventories is deducted from the inventor's figure shown in the group statement of financial position. A reduction in closing inventory causes an increase in the cost of sales, so the group's cost of sales figure must be increased by the amount of any unrealized profit.
- Others intra group items that may arise include interest payable by one group member to another and management expenses charged by one group member to another.
- Any dividends paid by a subsidiary to its parent company are cancelled against the dividends received which are shown in the parent statement of comprehensive income.
- If goodwill as suffered an impairment loss during the period, this loss is shown as an expense in the group of statement of comprehensive income.
- If the group includes any partly owned subsidiaries, part of the group's profit after tax is attributable to non-controlling interests. This amount is deducted in the group statement of comprehensive income.

The purpose of a group statement of changes in equity is to show each component of groups equity has changed during the accounting period.

If a subsidiary is acquired part of the way through the accounting period for which group accounts are being prepared, it is necessary to apportion the new subsidiaries profit for that period into its pre-acquisition and post-acquisition components. The group's share of the subsidiary pre-acquisition profits is cancelled out in the calculation of goodwill arising on consolidation. The group's share of the subsidiary post acquisition profit is included in the consolidated statement of comprehensive income.

IAS28 – Investment in Associates and Joint Ventures

ASSOCIATE: an entity over which the investor as a significant influence

SIGNIFICANT INFLUENCE: the power to participate in the financial and operating policy decisions of the investee, but not in control or joint control of those policies.

When the investor company holds at least 20% of the voting power of any investee company, significant influence is presumed to exist unless it can be clearly demonstrated that this is not the case.

IAS28 also states that significant influence is presumed not to exist if the investor holds less than 20% of the voting power of the investee unless such influence can be clearly demonstrated. The existence of significant influence is usually evidenced in one or more of the following ways:



- Representation on the board of directors which governs the investing company.
- Participation in policymaking processes of the investee, participation in decisions about dividends and other distributions
- Material transactions between the investor and the investee
- Interchange of managerial personnel
- Provisions of essential technical information

An investor company loses its significant influence over an investee company when it loses the power to participate in the investee's financial and operating policies. This generally occurs when the investor no longer holds at least 20% of the investee's voting power.

IAS28 requires that an investment in an associate should normally be accounted for using the equity method.

EQUITY METHOD: a method of accounting whereby the investment is initially recognised at the cost and adjusted thereafter for the post acquisition change in the investor's share of the investee's net assets.

A parent company which is exempt from applying the equity method will usually prepare its own separate financial statements in which investments in associate may be shown either at cost or in accordance with IFRS9.

Under the equity method of accounting, the investment made by the investing company is recorded initially at cost. This will include goodwill if the cost of investment is greater than the investor's share of the fair value of the investee's identifiable net assets. Any goodwill included in the cost of an investment accounted for by equity method is not separately recognised. Nor is it separately tested for impairment. But the amount paid is recognised as income in the investor's statement of comprehensive income and is added to the carrying amount of the investment in the investor's statement of financial position.

- The investor's share of the investee's profit for the year is recognised as income in the investor's statement of comprehensive income and is either added or subtracted from the carrying amount of the investment in the investor's statement of financial position.
- The investor's share of the investee's other comprehensive income for the year is recognised as other comprehensive income in the investor's statement of comprehensive income and is either added or subtracted from the carrying amount of the investment.
- Any dividends received from the investee are subtracted from the carrying amount of the investment.

IAS28 uses terms *upstream* and *downstream* to refer to transactions between an investor and an associate. An example of upstream transaction is the sale of goods from the associate to the investor. An example of downstream transaction is the sale of goods by the investor to the associate. The standard requires that any unrealized profits resulting from such transactions should be eliminated to the extent of the investor's interest in the associate.

- **Upstream:** in the investor's financial statements, the unrealized profit is subtracted from the investor's share of profit from associates. This automatically reduces the investment in associate figures shown in the statement of financial position.
- **Downstream:** in the investor's financial statements, the unrealized profit is subtracted from gross profit and is also subtracted from the investment in associate figure shown in the statement of financial position.

The investor's share of an associate's loss is recognised as an expense in the investor's financial statements and is subtracted from the carrying amount of investment. However, if the investor's share of an associate's loss is greater than the carrying amount of investment, that amount is reduced to zero and then the investor should normally recognise that no further losses are recognised if the investor has incurred legal or constructive obligation on behalf of the associate. This situation might occur if the investor has guaranteed the



associate's debts. If the carrying amount of the investment is reduced to 0 but the associate eventually returns to profit, the investor should not resume recognition of its share of the associates profit until after those profits have cancelled out the losses which were not recognised with the carrying amount of the investment was 0.

The entire carrying amount of the investment should be tested for impairment whenever there is an indication of that an impairment may have occurred. As usual, an impairment test involves comparing the carrying amount of investment with the higher of its values and its fair value less costs of disposal.

If the reporting period of an investor and an associate are different, the associate should prepare additional financial statements for the investor, using the same reporting period as the investor. If this is impracticable, the financial statements of the associate should be adjusted to account of any significant transactions or events which occur between the end of the associated reporting period and the end of the investors reporting. The investors financial statements should be prepared using uniform accounting policies.

IFRS11 – Joint Arrangements

A joint arrangement exists if two or more parties exercise joint control over a business enterprise.

JOINT ARRANGEMENT: an arrangement of which two or more parties have joint control.

JOINT CONTROL: 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.

Important characteristic of a joint agreement that distinguishes it from a subsidiary or an associate is that there is a contractual agreement to share control. Without such agreement, joint control cannot exist.

IFRS11 identifies two types of joint agreement and prescribed the accounting treatment of each:

- **JOINT OPERATIONS:** a joint arrangement whereby the parties that have joint control of that arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. The agreement between these joint operations would specify the way in which the revenue and expenses of the operation should be shared between them. A joined arrangement that is not structured as a separate vehicle must be a joint operation.
- **JOINT VENTURES:** a joint arrangement whereby the parties that have joint control on the arrangement have rights to the net assets of the arrangement. The joint ventures would each have an interest in the net assets of the arrangement, generally by virtue of their ownership of shares in the separate entity concerned. In most cases, a joint arrangement that is structured as a separate vehicle would be regarded as a joint venture.

IFRS11 specifies the required accounting treatment of each type of joint arrangement.

- **Joint operations:** the financial statements of each joint operator should recognise:
 - Its assets that are being used in the joint operation, including its share of any assets that are held jointly.
 - Its liabilities that relate to the joint operation, including its share of any liabilities that are incurred jointly.
 - Its share of revenue arising from the joint operation.
 - Its share of the expenses arising from the joint operation.
 - There is no need to prepare financial statements for the joint operation itself.
- **Joint ventures:** a joint venture should recognise its interest in a joint venture as an investment in its own financial statement. **This investment should normally be accounted for by the equity method. It will also be necessary to prepare financial statements for the joint venture itself.**



The entity should also disclose information which enables the users of its financial statements to evaluate:

- The nature, extent and financial effects of its interests in associate's and its interests in joint arrangements.
- The nature of any risk associated with its interests in associates and joint one arrangement.

IAS36 – Impairment of Assets

The aim of this standard is to ensure that an entity's assets are not carried in the financial statements at more than their recoverable amounts. The exclusion of inventories and most financial assets means that, in practice, the standard is mainly applicable to noncurrent assets.

IMPAIRMENT LOSS: the amount by which the carrying amount of an asset or a cash generating unit exceeds its recoverable amount.

CASH GENERATING UNIT: the smallest identifiable group of assets that generates cash inflows that are largely independent of cash inflows from other assets or group of assets.

IAS36 requires an entity to determine the recoverable amount of an asset only if there is some indication that the asset might be impaired. The standard provides some examples:

- *External sources of information:*
 - Observable indications that an asset's value has declined during the period by significantly more than expected.
 - Significant and adverse changes have occurred in the technological, market, economic or legal environment in which the entity operates.
 - Interest rate increases have occurred which are likely to increase the discount rate used in calculating an assets value in use.
 - The carrying amount of the entity's net assets exceeds its market capitalization.
- *Internal sources of information:*
 - There is evidence of obsolescence of an asset.
 - Significant and adverse changes have occurred.
 - The asset is becoming idle.
 - Plans to discontinue the operation in which the asset is used.
 - Plans to dispose of the asset.
 - Reassessing the assets useful life as finite ever then indefinite
 - There is evidence that the economic performance of an asset is worse than expected.

IAS36 also points out that if there were indication that an asset might be impaired, these indications might also suggest that the entity should review the assets useful life and residual value and review the depreciation or amortisation method being used.

There are two types of assets for which recoverable amount must be determined annually:

- **intangible assets which have an indefinite useful life, or which are not available for use.**
- **goodwill acquired in a business combination**

RECOVERABLE AMOUNT: the higher of an asset's fair value less cost of disposal and its value in use.

COST OF DISPOSAL: incremental costs directly attributable to the disposal of an asset or cash generating unit, excluding finance costs and income tax expense

VALUE IN USE: the present value of the future cash flows expected to be derived from an asset or a cash generating unit.



An asset fair value normally differs from its value in use because value in use may reflect factors that are specific to the entity concerned and not applicable to market participants in general. The cost of disposals includes items such as legal costs, stamp duty, cost of removing the asset and direct costs that would be incurred to bring the asset into a condition suitable for sale.

An asset value in use is calculated by discounting the future cash flows which asset is expected to generate:

- projections of future cash inflows from the use of the asset
- projections of future cash outflows that will be necessary incurred so as to generate cash inflows from the use of the asset.
- net cash flows to be received or paid on disposal of the asset at the end of its useful life.

Future cash flows should be estimated for the asset in its current condition and should not take into account any cash flows which are expected to arise from improving or enhancing the assets performance. They should not include cash inflows or outflows from financing activities or tax receipts or payments. The discount rates used in calculating an assets value in use should be a pretax interest rate which reflects the current market assessment of the time value of money.

If the recoverable amount of an asset being less than its carrying amount, IAS36 requires that the assets carrying amount should be reduced to its recoverable amount. An impairment loss should be recognised as an expense. If the asset is carried at a revalued amount, the impairment losses accounted for in the same way as a revaluation decrease.

- The impairment loss is debited to the revaluation reserve and then shown in other comprehensive income to the extent of any credit balance previously existing in there with elevation reserve in respect of that same asset.
- any excess is then recognised as an expense.

After an impairment loss has been recognised, subsequent depreciation or amortisation charges should allocate the assets revised carrying amount.

If the recoverable amount of an individual asset which might be impaired cannot be determined, the recoverable amount of the CGU to which the asset belongs should be determined instead; then an impairment loss should be recognised if the CGU's recoverable amount is less than its carrying amount.

The recoverable amount of a CGU is the higher of its fair value less cost of disposal and its value in use:

- includes the carrying amount of only those assets that can be attributed directly to the CGU, and which will generate the future cash inflows used in determining the CGU's value in use.
- excluded the carrying amount of the CGU liabilities, unless the CGU's recoverable amount cannot be determined without taking those liabilities into account.

Goodwill does not generate cash flows independently of other assets and so it must be allocated between CGU for impairment testing purposes. If the goodwill cannot be allocated between individual CGU's; it is allocated between group of CGUs to which the goodwill relates. Impairment testing then proceeds as follows:

- In an individual CGU, by comparing its carrying amount (including goodwill), with its recoverable amount.
- A group of CGUs tested annually for impairment by comparing the carrying amount of the group (including goodwill), with the group's recoverable amount.
- An individual CGU to which no goodwill has been allocated should be tested only if there are indications of impairment.

CORPORATE ASSETS: assets other than goodwill that contribute to the future cash flows of both the cash generating units under review and other cash generating units. Corporate assets do not generate cashflow independently from other assets and therefore they must be allocated between CGUs for impairment testing purposes.



- An individual CGU to which a portion of corporate assets has been allocated should be tested for impairment by comparing its carrying amount (including the corporate asset) with its recoverable amount.
- A group of CGUs which a portion of corporate asset has been allocated should be tested for impairment by comparing the carrying amount of the group (including the corporate asset) with the group's recoverable amount.
- An individual CGU to which no portion of corporate asset has been allocated should be tested by comparing the CGU carrying amount with its recoverable amount in the usual way.

An impairment loss must be recognised if the recoverable amount of CGU is less than its carrying amount. These losses are recognised by reducing the carrying amount of CGUs assets:

- first, to any goodwill which has been allocated to the CGU.
- next, to the other assets of the CGU, in proportion to their carrying amounts

When allocating an impairment loss between the assets of a CGU, the carrying amount of an asset should not be reduced below the highest of:

- The assets fair value less cost of disposal
- The assets value in use
- 0

The amount of the impairment loss that would otherwise have been allocated to the asset concerned should be allocated pro rata between the other assets of the CGU.

If impairment losses have been recognised in previous accounting periods, IAS36 requires the entity to assess whether there are any indications that these impairment losses have now decreased or no longer exist:

- *External sources of information:*
 - Observable indications that an asset's value has increased significantly during the period.
 - Significant and favourable changes have occurred in the technological, market, economic or legal environment.
 - Interest rate decreases have occurred which are likely to reduce the discount rate used in calculating an assets value in use.
- *Internal sources of information*
 - Significant and favourable changes have occurred in the extent to which or the manner in which the asset is used.
 - There is evidence that the economic performance of an asset is better than expected.

A previously recognised impairment loss cannot be reversed unless there has been a changing estimate used when the impermanent loss was recognised. There reversal of an impairment loss for a CGU should be allocated between the asset of a CGU (over then goodwill) pro rata to the carrying amounts of those assets. When an impairment loss in relation to an asset is reversed, the assets increased carrying amount should not exceed the carrying amount which would have applied if there had been no impairment loss in the first place. After the reversal of an impairment loss, subsequent depreciation or amortisation charges should allocate the assets revised carrying amount.

IAS36 states that an impairment loss recognised for goodwill shall not be reviewed in a subsequent period.

IAS37 – Provisions, Contingent Liabilities and Contingent Assets

The aims of the standard are to:

- ensure all necessary provisions are recognised and accurately measured in the financial statements of business entities.



- to prevent the recognition of unjustified provisions
- to prescribe an accounting treatment for contingent liabilities and contingent assets
- to ensure that sufficient disclosure is made, so as to enable users to understand the nature, timing and amount of provisions, contingent liabilities, and contingent assets.

PROVISION: a liability of uncertain timing or amount. A provision should be recognised when all of the following conditions are satisfied:

- the entity as a present obligation as a result of a past event
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
- a reliable estimate can be made author the amount of the obligation.

The amount of the provision should be equal to the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

OBLIGATING EVENT: a past event which leads to a present obligation. The business entity involved must have no realistic alternative but to settle the obligation created by the event. This will be the case if:

- the obligation is legally enforceable or
- the entity as a constructive obligation

CONSTRUCTIVE OBLIGATION: an entity as indicated that it would accept an obligation and there has created a valid expectation in other parties that it will discharge that obligation, even though it is not legally enforceable.

Without an obligating event there cannot be a provision. It should be stressed that a provision is recognised only if the obligation in question exists independently of the entity's future actions. No provision can be made in relation to future operating costs since this could be avoided by changing the method of operating or by ceasing the operations concerned.

Provisions cannot be recognised unless it is probable that an outflow of economic benefits will be required to settle the obligation in question. For this purpose, the word *probable* means more likely than not. If a number of similar obligations exist at the end of a reporting period, the standard requires that the probability of an outflow of benefits should be assessed by considering the class of obligations as a whole.

If a reliable estimate cannot be made, a liability exists but a provision cannot be recognised. This liability must be disclosed as a contingent liability.

The best estimate of the required expenditure is the amount that the entity would rationally pay to settle the obligation or transfer it to a third party. If the effect of the time value of money is material, the amount of a provision should be calculated as the present value of the expenditure required to settle the obligation.

IAS37 requires that provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate of the required expenditure. If it is no longer probable that an outflow of economic benefits will be required to settle an obligation, the related provision should be reversed. The standard requires that a provision should be used only for the purpose for which it was originally established.

Future operating losses are not a present obligation and so do not satisfy the recognition criteria for a provision. Provisions should not be recognised for future operating losses.

ONEROUS CONTRACT: a contract in which the unavoidable costs of meeting the obligation under the contract exceed the economic benefits expected to be received under it.

The present obligation of an onerous contract should be recognised as a provision. The amount of the provision is the lower of the net cost of fulfilling the contract and any penalties payable as a result of failing to fulfil it.

Restructuring cost should be recognised only if the general recognition criteria are satisfied:



- A constructive obligation to restructure arises only when the 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, either by beginning to implement the plan or by announcing its main features.
- If the restructuring is involving the sale of an operation, no obligation for that sale arises until there is a binding sale agreement.
- A provision for restructuring should include only the direct cost arising from the restructuring. These costs must be necessarily incurred and must not be associated with the ongoing activities of the entity.

Staff retraining and relocation costs, marketing costs, and the cost of the investment in new systems cannot be included in the amount of the provision for restructuring costs. IAS37 does apply to short term leases if they become onerous.

CONTINGENT LIABILITY: a possible obligation that arises from past events and whose existence would 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 it is not recognised because:

- it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
- the amount of the obligation cannot be measured with a sufficient reliability.

CONTINGENT ASSET: a possible asset that arises from past events and that 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. Contingent assets should not be recognised as assets in the statement of financial position. Contingent assets should be disclosed in the notes if the inflow of economic benefits is judged to be probable.

IAS10 – Events after the reporting period

IAS10 prescribes the accounting treatment of events which occur after the end of the reporting period but before the date on which the financial statements are authorised for issue.

EVENTS AFTER THE REPORTING PERIOD: 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.

ADJUSTING EVENTS: those that provide evidence of conditions that existed at the end of reporting period.

Examples include the settlement of a court case in which the company was involved at the end of a reporting period; the bankruptcy of a customer who owed money to the company at the end of the reporting period; the discovery of fraud or errors which show that the financial statements for the period are incorrect.

NON-ADJUSTING EVENTS: those that are indicative of conditions that arose after the reporting period.

IAS10 requires that the financial statements should be adjusted to reflect adjusting events that occur after the reporting period, but material non adjusting events should be disclosed in the notes to the financial statements.

Dividends to equity shareholders which are declared after the end of the reporting period but before the financial statements are authorised for the issue do not qualify as a present obligation at the end of the period and so should not be recognised as a liability.

IFRS16 – Leases

The IASB Conceptual Framework states that financial information cannot faithfully represent transactions unless it represents their underlying economic substance rather than just their legal form. This principle is embodied in IFRS16 Leases, which deals with the accounting treatment of leased items such as property, plant, and equipment. The legal form of a lease is that ownership of the leased item remains with the lessor (the supplier) and is not transferred to the lessee (the user). However, the underlying substance of most leases is that the lessee acquires an asset and incurs a corresponding liability to the lessor. In such cases, IFRS16 requires that a "right-of-use" asset and the liability to the lessor should be recognised in the lessee's financial statements.



LEASE: a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

INCEPTION DATE OF A LEASE: 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.

COMMENCEMENT DATE OF A LEASE: the date on which a lessor makes an underlying asset available for use by a lessee.

At the inception of a contract, an entity should assess whether or not the contract meets the definition of a lease. If so, the requirements of IFRS16 must be applied. For a contract to qualify as a lease, it must convey the right to control the use of the underlying asset for a period of time. Throughout the "period of use" specified in the contract, the customer must have both of the following:

- the right to obtain substantially all of the economic benefits from use of the underlying asset, and
- the right to direct the use of that asset.

A customer has the right to direct the use of an asset if the customer controls the way in which the asset is used and the purpose(s) for which it is used (within the scope of its right of use defined in the contract).

LEASE TERM: the non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

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

RIGHT-OF-USE ASSET: *an asset that represents a lessee's right to use an underlying asset for the lease term.*

IFRS16 requires that, at the commencement of a lease, the lessee should recognise a right-of-use asset and a corresponding lease liability. The requirement to recognise a right-of-use asset and a lease liability generally applies to all leases. However, an entity may elect not to apply this accounting treatment to:

- short-term leases (leases of 12 months or less), and
- leases for which the underlying asset is of low value.

If such an election is made, the lease payments for the leases concerned are recognised as an expense and spread over the lease term (usually on a straight-line basis).

The assessment of whether an asset is of low value should be carried out on an absolute basis, not a materiality basis. Examples given in the application guidance include personal computers and small items of office furniture. The *Basis for Conclusions* for IFRS16 suggests that assets with a value not exceeding 5.000 US dollars might be regarded as low-value assets.

The right-of-use asset which is recognised at the commencement of a lease is measured initially at cost. The cost of the right-of-use asset is obtained by adding together the following elements:

- the amount of the initial measurement of the lease liability
- any lease payments made at or before the commencement date (e.g. deposits)
- any initial direct costs incurred by the lessee.
- an estimate of any costs to be incurred by the lessee in dismantling or removing the underlying asset at the end of the lease term, restoring the site on which it is located or restoring the asset as required by the terms of the lease.

The lease liability which is recognised at the commencement date is measured initially at the present value of the lease payments which fall due after that date. These payments should be discounted at the interest rate implicit in the lease (if this is known) or at the lessee's incremental borrowing rate otherwise. These rates are as follows:

- The "interest rate implicit in the lease" is equal to the rate of interest which causes the present value of:



- the lease payments made by the lessee during the lease term, and
- the estimated residual value of the underlying asset for the lessor (if any) at the end of the lease term
- A lessee's "incremental borrowing rate" is the rate of interest that the lessee would have to pay over a similar term to borrow the funds necessary to acquire an asset of a similar value to the leased asset.

In most cases, the right-of-use asset established at the commencement of a lease should be measured subsequently at cost less any accumulated depreciation and accumulated impairment losses (the "cost model"). The asset should be depreciated in accordance with IAS16, and impairment losses should be accounted for in accordance with IAS36. Note that:

- If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term (or if the lessee is expected to exercise a purchase option) the right-of-use asset should be depreciated up to the end of the useful life of the underlying asset.
- Otherwise, the right-of-use asset should be depreciated up to the *earlier* of the end of the lease term and the end of the useful life of the right-to-use asset. However, if the right-of-use asset relates to a class of property, plant, and equipment to which the lessee applies the revaluation model then the revaluation model may also be applied to the right-of-use asset. Similarly, if the lessee applies the fair value model to investment property, then the fair value model should also be applied to any right-of-use assets which meet the definition of investment property.

As regards the lessee's liability to the lessor, each lease payment is apportioned between the interest (or finance charge) element (which is recognised as an expense) and the amount which reduces the outstanding liability. IFRS16 requires that interest on the liability should be calculated in such a way as to produce "*a constant periodic rate of interest on the remaining balance of the lease liability*". The interest rate applied should be the discount rate which was used when initially measuring the lease liability.

IFRS16 requires that lessors should classify each of their leases (at the inception date) as either a "finance lease" or an "operating lease".

- **FINANCE LEASE:** a lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.
- **OPERATING LEASE:** a lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

Situations which would normally lead to a lease being classified as a finance lease include:

- the lease transfers ownership of the asset to the lessee by the end of the lease term
- the lessee has the option to purchase the asset at a price expected to be sufficiently lower than the asset's fair value on the date that the option is exercisable, so as to make it reasonably certain (at the inception date) that this option will be exercised.
- the lease term is for a major part of the economic life of the asset.
- at the inception date, the present value of the lease payments amounts to (at least) substantially all of the fair value of the underlying asset.
- the underlying asset is of such a specialised nature that only the lessee could use it without major modifications.

The factors illustrated are not always conclusive. If it is clear from other features of the lease agreement that a lease does not transfer substantially all of the risks and rewards of ownership, then the lease will be classified as an operating lease.

For a lease of both land and buildings, the land element and the buildings element should be considered separately for the purposes of lease classification. In such a case, the lease payments are allocated between the elements of the lease in proportion to the fair values of the leasehold interests in the land element and the buildings element at the inception date. Leases of land are classified as either finance leases or operating leases in the same way as other assets. However, land normally has an indefinite economic life and so a lease of land cannot be for "a major part of the economic life of the asset". Nonetheless, the risks and rewards incidental to



the ownership of land can be transferred to the lessee if legal title is expected to be transferred by the end of the lease term or if the lease is for such a long period (e.g. several decades) that the present value of the residual value of the land at the end of the lease is negligible.

At the commencement date of a finance lease, the lessor is required to recognise the asset held under the lease as a receivable equal to the "net investment" in the lease. This amount is initially measured at the present value of:

- the lease payments receivable by the lessee after the commencement date, plus
- the estimated residual value of the underlying asset for the lessor (if any) at the end of the lease term.

The discounting rate used in this calculation is the interest rate implicit in the lease.

The net investment figure will be equal to the fair value of the underlying asset at the commencement of the lease, less any payments received from the lessee on or before that date, plus any initial direct costs which are borne by the lessor. The income element of each payment made by the lessee is recognised as finance income in the lessor's statement of comprehensive income. At the end of the lease term, the net investment figure will be equal to any residual value (for the lessor) of the underlying asset.

If a lease is classified as an operating lease, the underlying asset should be shown in the lessor's financial statements and then depreciated as usual. The lease payments made by the lessee are recognised as income, generally on a straight-line basis over the lease term. Any direct costs incurred by the lessor on arranging an operating lease should be added to the carrying amount of the asset concerned and written off over the lease term.

The main disclosure requirements of IFRS16 for lessors are as follows:

- Finance leases:
 - the amount of finance income for the reporting period
 - a maturity analysis of lease payments receivable, showing undiscounted amounts to be received in each of the following five years and the total to be received in remaining years (reconciled to the net investment in finance leases)
- Operating leases:
 - the amount of lease income for the reporting period
 - a maturity analysis of lease payments receivable, showing undiscounted amounts to be received in each of the following five years and the total to be received in remaining years.

A "sale and leaseback" transaction occurs when an entity (the "seller-lessee") sells an asset to another entity (the "buyer-lessor") and then immediately leases the asset back from that other entity. The outcome of such a transaction is that the seller-lessee continues to use the asset concerned for a period of time, even though it has been sold to the buyer-lessor.

The requirements of IFRS16 with regard to sale and leaseback transactions are broadly as follows:

- **Transfer of the asset is a sale.** If the transfer qualifies as a sale (i.e. the buyer-lessor has obtained control), the seller-lessee should derecognise the transferred asset and recognise a right-of-use asset instead. The profit/loss on disposal is restricted in proportion "*to the rights transferred to the buyer-lessor*". The buyer-lessor accounts for the purchase of the asset by applying the relevant standard and accounts for the lease to the seller-lessee by applying IFRS16.
- **Transfer of the asset is not a sale:** The transfer proceeds are treated as a loan and are recognised as a financial liability for the seller-lessee and a financial asset for the buyer-lessor.

IFRS15 – Revenues from contracts with customers

The purpose of this standard is to establish the principles that an entity should apply to report useful information in the financial statements concerning the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with the customer.

REVENUE: income arising in the course of an entity's ordinary activities



INCOME: increases in economic benefits during the accounting period, in the form of increasing or enhancements of assets or decreases of liabilities that results in an increase in equity, other than those relating to contributions from equity participants

CUSTOMER: a party that has contract with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

Revenue arises from ordinary activities and excludes:

- **Borrowings**
- **Amounts contributed by shareholders**
- **Gains (revaluation gains and gains arising on the disposal of noncurrent assets)**

The main exclusions and the applicable standards are:

- **Rental income (IFRS16)**
- **Interest and dividends, financial instruments (IFRS9)**
- **Biological assets**

The standard does not apply to licences of intellectual property. These include items such as software licences, franchises, copyright licences.

The principal of IFRS15 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 goods or services. This can be done in five steps:

1. **IDENTIFY A CONTRACT WITH A CUSTOMER**

CONTRACT: an agreement between two or more parties that creates enforceable rights and obligations.

The standard states that a contract which falls within its scope should be accounted for by an entity only when all of the following conditions are satisfied:

- The parties concerned have approved the contract and are committed to perform their contractual obligations.
- The entity can identify each party's rights with regard to the goods or services which are to be transferred under the contract.
- The entity can identify the payments terms for the goods and services to be transferred.
- The contract has commercial substance (the entity's cash flows are expected to change as a result of a contract).
- It is probable that the entity will collect the consideration to which is entitled in exchange for the goods or services that will be transferred to the customer.

A contract should not be accounted for if the contract is wholly unperformed and each party to the contract has the unilateral enforceable right to terminate it. A contract is wholly unperformed if the entity has not yet transferred any goods or services to the customer and has not yet received any payment. A payment which is received from a customer before all of the conditions listed above are satisfied must be recognised as a liability.

IFRS15 requires that two or more contracts that are entered into with the same customer at the same time (or near) should be combined and accounted for as a single contract if:

- The contracts are negotiated as a package with a single commercial objective, or
- The consideration payable in one contract depends upon the price or performance of the other contract, or
- The goods or services to be transferred to the customer by virtue of the contracts comprise a single performance obligation.

A contract modification will be treated as a separate contract for the purposes of IFRS15 if:

- The modification adds distinct goods or services to the contract.



- The contract price increases by an amount that reflects the standalone price of the additional goods or services which are to be transferred.

2. IDENTIFY THE PERFORMANCE OF OBLIGATION IN THE CONTRACT

PERFORMANCE OBLIGATION: a promise in a contract the with a customer to transfer to the customer either:

- A good or service (or a bundle of goods and services) that is distinct, or
- A series of instinct good or service that is substantially the same that have the same pattern of transfer to the customer.

A good or service is regarded as distinct if both of the following conditions are satisfied:

- The customer could benefit from the good or service either on its own or together with other resources that are readily available to the customer. If a particular good or service is regularly sold separately by the entity, this would usually indicate that a customer could benefit from the good or service on its own.
- The promise to transfer the good or service to the customer is separately identifiable from other promises in the contract. Factors which indicate that a promise to transfer a good or service is not separately identifiable include:
 - The good or service is significantly integrated with our goods or services that are promised in the contract.
 - The good or service modifies or customise other goods or services that are promised in the contract.
 - The good or service is highly interdependent with our goods or services that are promised in the contract.

If a promised good or service is not distinct, the entity should combine that good or service with other goods or services that are promised in the contract so as to form a bundle of good and services that is distinct.

3. DETERMINE THE TRANSACTION PRICE

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. The exclusion of amounts collected on behalf of third parties are not regarded as revenue [ex. sales taxes, such as VAT]. Nor are amounts collected by an agent on behalf of a principal.

IFRS15 requires that the entity concerned should estimate the amount of consideration for the contract by using either the expected value method or the most likely amount. The chosen the method should be the one which best predicts the amount of consideration to which the entity is entitled.

- Expected value: is identified by multiplying all possible amounts of the variable consideration by their associated probabilities and then adding the weighted amounts.
- Most likely amount: this method picks the single most likely amount from the range of possible amounts or the variable consideration. This may be a suitable approach if there are in fact only two possible amounts [ex. If a specified performance bonus will either be received in full or not received at all].

In the case of a contract which falls into more than one accounting period. it is necessary to update the transaction price at the end of each period, so as to reflect the circumstances present at the end of that period. A contract contains a significant financing component if the agreed date of payment by the customer is later than the date on which goods or services are transferred and the effects of time value of money are significant. Part of the consideration should be treated as finance income. This adjustment is not required if the period between the transfer of goods or services and payment date does not exceed one year.

4. ALLOCATE THE TRANSACTION PRICE TO PERFORMANCE OBLIGATION IN THE CONTRACT

IFRS15 requires the transaction price to be allocated between performance obligations on the basis of the standalone selling price of each obligation. If the total transaction price for the contract is less than the sum of the standalone selling prices of each performance obligation, the customer is effectively receiving a discount for purchasing a bundle of goods and services. Such discount is usually allocated proportionately amongst performance obligations. If part of the transaction price is variable, the variable amount is allocated to a single performance obligation if it relates specifically to that obligation. Otherwise, the variable amount is allocated



between the performance obligations. If the transaction price changes after contract inception, the amount of the change is allocated amongst performance obligation on the same basis as the allocation of the original transaction price.

5. RECOGNISE REVENUE WHEN OR AS A PERFORMANCE OBLIGATION IS SATISFIED

The amount of revenue recognised is the amount of the transaction price which was allocated to the satisfied performance obligation. For each performance obligation in a contract, it is necessary for the entity to determine whether that obligation is satisfied over time or at point in time.

An entity is regarded as transferring control of a good or services over time if any of the following conditions are satisfied:

- The customer simultaneously receives and consumes the benefits that are provided by the entity's performance as the entity performs its obligation.
- The entity's performance creates an asset that the customer controls as it is created.
- The entities performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for the performance that has been completed to date.

For each performance obligation that is satisfied over time, the entity should recognise revenue over time by measuring the progress made towards complete satisfaction or the obligation:

- Output methods: this method measures progress on the basis of direct measurements of the goods and services transferred to date, relative to the goods and services that remain to be transferred.
- Input methods: this method measures progress on the basis of an entity's efforts or inputs to date relative to the total expected inputs required in order to achieve performance obligations.

Point in time revenue will be recognised when the customer obtains control of the promised asset and the obligation is satisfied:

- The entity is now entitled to payment for the goods or services provided.
- The customer has legal title to the asset concerned.
- The entity as transferred physical possession of the asset.
- The customer now as the significant risks and rewards which would normally be associated with ownership of the asset.
- The customer is accepted the asset.

If any of the costs incurred by the entity do not fall within the scope of another international standard, they may be recognised as an asset only if:

- The costs relate directly to a specific contract with a customer, and
- The costs generate resources that will be used in satisfying performance obligations in the future, and
- The costs are expected to be recovered.

Contract costs that have been recognised as an asset are reclassified as an expense when the related goods or services are transferred to the customer and revenue is recognised:

- If a performance obligation is satisfied at that point in time, the related contract costs will be reclassified as an expense when the obligation is satisfied.
- If a performance obligation is satisfied over time, contract costs will be reclassified as an expense each time that the state of progress of the contract is measured, and the associated revenue is recognised.

IFRS15 also requires that an impairment loss should be recognised if the carrying amount of a contract costs that have been recognised as an asset exceeds: the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the contract assets relates, LESS the remaining cost that will be incurred in providing those goods or services.



If an entity has performed an obligation by transferring goods or services to the customer and the customer has not yet paid the goods or services, the entity should present a contract asset in its statement of financial position. A contract asset is recognised when the entity's right to consideration is conditional on something other than the passage of time [ex. Future performances for the entity. A constructor that builds an hospital, in order to receive money, has also to clean up the site]

A receivable is recognised when the entity's right to consideration is unconditional except for the passage of time. In general, amounts are presented as a receivable only when the customer has been invoiced.

Similarly, a contract liability should be presented in the statement of financial position if payment is made before the entity transferred the goods or services to the customer.

The standard requires that the entity should disclose:

- For performance obligations that are satisfied over time, the methods used to measure the progress made towards satisfaction of those obligations.
- For performance obligations that are satisfied at a point in time, the judgments made as so as to determine when a customer obtains control of goods or services.
- Other significant judgments relating to matters such as determining transaction prices, estimating variable consideration, and allocating transaction prices.

Sales with a right of return: if customers are granted the right to return products and obtain a refund, the entity should estimate the expected returns and recognise as revenue only the amount of consideration to which it is expected to be entitled. If the customer pays more than this amount, the entity should also recognise the refund liability for the amount.

Warranties: if the customer has the option to purchase a warranty separately, the warranty which presents a distinct performance obligation and part of the transaction price should be allocated to it. However, if the warranty cannot be purchased separately, it should normally be accounted for in accordance with the IAS37.

Repurchase agreements: if the repurchase price is less than the original selling price, the entity should account for the contract as a lease in accordance with IFRS16. Otherwise, the contract should be treated as a financing agreement.

Consignment arrangements: if a product is shipped to a recipient who undertakes to sell those goods on behalf of the shipper, revenue should not be recognised by the shipper until the goods have been sold to a third party.

Bill and hold arrangements: these are contracts where the entity invoices a customer for a product but then retains physical possession of a product until such time as the customer requests delivery. For these contracts, the entity concerned should determine whether or not the customer has yet obtained control of a product and should recognise revenue only if this is the case.

IAS12 – Income Taxes

It is important to appreciate that IAS12 is solely concerned with accounting for taxation and is not concerned with the actual calculation of tax liabilities. IAS12 deals with any taxes payable on the profits of an entity, no matter what those taxes might be called in different countries.

The amount of current tax for an accounting period should generally be recognised as an expense (or as income in the case of tax recoverable) and should be included in the calculation of profit or loss.

Any current tax arising from an item that is recognised in "other comprehensive income" in the statement of comprehensive income should also be recognised in other comprehensive income:

- revaluation surpluses arising in relation to property, plant, and equipment or intangible assets.
- certain foreign exchange differences.



Any current tax that arises from an item which is recognised directly in the statement of changes in equity should also be recognised in the statement of changes in equity. One example of such an item is an adjustment to the opening balance of retained earnings resulting from the retrospective application of an accounting policy or the correction of a prior period error.

Any current tax that remains unpaid at the end of the period should be recognised as a liability. If the amount already paid exceeds the amount due, the excess should be recognised as an asset. The benefit relating to a tax loss that can be carried back to recover current tax of a previous period, should also be recognised as an asset.

Current tax should be measured using tax rates and tax laws "that have been enacted or substantively enacted by the end of the reporting period". Tax rates and tax laws which have been announced but not enacted by the end of the period can be treated as "substantively enacted" if their enactment is regarded as more or less a formality. Tax rates and laws announced after the end of the reporting period are dealt with as non-adjusting events in accordance with the requirements of IAS10.

Any adjustments necessary so as to reflect underestimates or overestimates of current tax in previous periods should be included in the tax expense for the current period and then (if material) disclosed separately in the notes. This accords with the requirements of international standard IAS8.

The amount of current tax payable by an entity for an accounting period depends upon the entity's taxable profit for that period. However, this taxable profit will often be different from the profit shown in the financial statements.

- **Permanent differences:** some of the income shown in the financial statements may not be chargeable to tax and some of the expenses shown in the financial statements may not be deductible for tax purposes.
- **Temporary differences:** some of the income or expenses shown in the financial statements for an accounting period may be dealt with for tax purposes in a different accounting period.

Permanent differences cause no accounting problems and can be ignored. But temporary differences might lead to a significant distortion of the reported figures for profit after tax. IAS12 solves the problem illustrated above by requiring entities to account for "deferred tax". The broad approach is as follows:

- In an accounting period in which temporary differences cause taxable profits to be lower than accounting profits, the tax expense which is shown in the statement of comprehensive income is increased by a transfer to a deferred tax account.
- In an accounting period in which temporary differences cause taxable profits to be higher than accounting profits, the tax expense which is shown in the statement of comprehensive income is reduced by a transfer from the deferred tax account.

IAS1 *Presentation of Financial Statements* requires that the balance on the deferred tax account should be shown as a non-current liability (or asset) in the entity's statement of financial position.

TAX BASE: the amount attributed to that asset or liability for tax purposes.

- **TAX BASE OF AN ASSET:** the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
- **TAX BASE OF A LIABILITY:** its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods.

TEMPORARY DIFFERENCES: differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

- **TAXABLE TEMPORARY DIFFERENCES:** temporary differences that will result in taxable amounts in determining taxable profit of future periods when the carrying amount of the asset or liability is recovered or settled. Taxable temporary differences result in deferred tax liabilities.



- **DEDUCTIBLE TEMPORARY DIFFERENCES:** temporary differences that will result in amounts that are deductible in determining taxable profit of future periods when the carrying amount of the asset or liability is recovered or settled.

This is why IAS12 defines the tax base of an asset in terms of the deduction that will be allowed for tax purposes against the economic benefits generated by that asset. If the benefits obtained from an asset are not taxable, there is no deferred tax problem. In these circumstances, the tax base of the asset is regarded as being the same as its carrying amount, so that there is no need for a deferred tax adjustment.

The settlement of a liability has no effect on accounting profit and usually has no effect on taxable profit either, so liabilities tend not to cause deferred tax problems. However, the settlement of a liability might in certain cases trigger a deduction from taxable profits. This is why IAS12 defines the tax base of a liability in terms of the amount of the deduction that will be allowed for tax purposes when the liability is settled.

The tax law of the country in which an entity resides may allow trading and other losses to be carried forward and deducted from future taxable profits, so reducing the tax payable on those profits. In these circumstances, IAS12 states that a deferred tax asset should be recognised, but only to the extent that it is probable that future taxable profits will be available against which the losses can be utilised.

- A deferred tax liability must be recognised for all taxable temporary differences.
- **A deferred tax asset must be recognised for all deductible temporary differences to the extent that it is probable that taxable profits will be available in the future against which these deductible temporary differences can be utilised.**
- The carrying amount of deferred tax assets must be reviewed at the end of each reporting period and reduced to the extent that it is no longer probable that taxable profits will arise against which they can be utilised.
- A deferred tax asset or liability must be measured at the tax rates that are expected to apply to the period in which the asset is realised or the liability is settled. These tax rates should be based upon tax rates and laws that have been enacted or substantively enacted by the end of the reporting period (see earlier in this chapter).
- **Deferred tax assets and liabilities must not be discounted**, even though they might not be realised or settled for many years. **IAS12 regards it as inappropriate to require or permit discounting because of the uncertain timing of the reversal of each temporary difference.**
- **Transfers to or from the deferred tax account should generally be recognised in the calculation of profit or loss.** However, a deferred tax transfer that arises from an item that is recognised in other comprehensive income or directly in equity should also be recognised in other comprehensive income or directly in equity. **Deferred tax assets and liabilities should not be offset in the statement of financial position unless the entity has a legally enforceable right to do so.**

IAS 19 – Employee Benefits

The categories of employee benefits identified in IAS19 are:

- short-term employee benefits
- post-employment benefits (e.g. pensions)
- other long-term employee benefits
- termination benefits.

IAS19 defines short-term employee benefits as "*employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service*". This indicates that short-term employee benefits are those which fall due either during the period in which the employee provides services to the employer or within twelve months of the end of that period.

It covers items such as:

- wages, salaries and employer's social security contributions
- short-term holiday pay and sick pay



- profit-sharing payments and bonuses payable within twelve months of the end of the period in which the related employee services are performed
- non-monetary benefits (e.g. medical care, company cars) for current employees.

The employer's financial statements for that period should usually recognise:

- an expense equal to the amount of the short-term employee benefits due in exchange
- for those services, and
- a liability (accrued expense) equal to any part of this expense that has not been paid by
- the end of the period.

IAS16 requires employee benefits to be capitalised if they arise directly from the construction or acquisition of an item of property, plant or equipment. **Note that short-term employee benefits are measured on an undiscounted basis.**

IAS19 uses the expression "short-term paid absences" to refer to paid employee absences (e.g. paid holidays and paid sick leave) which occur during the period in which the related employee services are performed, or which are expected to occur within twelve months of the end of that period. Entitlement to paid absences falls into two categories:

- "accumulating" paid absences, which can be carried forward and used in a future period if the current period's entitlement is not used in full
- "non-accumulating" paid absences, which cannot be carried forward.

In the case of accumulating short-term paid absences, the employer's statement of financial position should show a liability equal to the expected amount payable during the following twelve months as a result of unused entitlement carried forward.

Profit-sharing and bonus payments that are payable within twelve months of the end of the period in which the employees render the related services are short-term employee benefits and should be recognised as an expense in that period, so long as:

- there is a present obligation to make the payments as a result of past events, and
- a reliable estimate of the obligation can be made

Profit-sharing and bonus payments which fall due more than twelve months after the end of the period are treated as "other long-term employee benefits".

Post-employment benefits consist mainly of retirement benefits, such as pensions. IAS19 distinguishes between two types of pension scheme or "plan":

- Defined contribution plans. Defined contribution plans are post-employment benefit plans where an employer pays fixed contributions into a pension fund each year and is not obliged to make any further contributions, even if the pension fund's assets are insufficient to pay the expected level of employee benefits. The risk that benefits will be less than expected falls upon the employees, not the employer.
- Defined benefit plans. Defined benefit plans are post-employment benefit plans where the employer is obliged (either legally or constructively) to provide an agreed level of post-employment benefits. The employer's contributions are not limited to any fixed amount, and these contributions may need to be increased if the pension fund does not have sufficient assets to pay the agreed level of benefits. The risk of having to make further contributions is borne by the employer, not the employee.

Accounting for defined contribution plans is straightforward. If an employee has rendered services to an employer during an accounting period, the employer's financial statements for that period should usually recognise:

- an expense equal to the amount of the contributions payable by the employer into the defined contribution plan in exchange for those services, and
- a liability (accrued expense) equal to any part of this expense that has not been paid by the end of the period. If the contributions already paid exceed the amount due to date, the excess should be recognised



as an asset (prepaid expense) to the extent that this prepayment will lead to either a reduction in future payments or a cash refund.

Contributions to a defined contribution plan are measured on an undiscounted basis unless they fall due more than twelve months after the end of the period in which employees render the related services. The amount recognised as an expense in relation to defined contribution plans should be disclosed in the notes which form part of the employer's financial statements.

Accounting for defined benefit plans is a complex matter and much of IAS19 is devoted to this topic. The complexity arises because the expense recognised in each accounting period should be the cost to the employer of the retirement benefits that will eventually be paid to employees as a result of the services they have provided during that period.

The employer is exposed to both the "actuarial risk" that employees will live longer than expected (which increases the cost of providing retirement benefits) and the "investment risk" that assets invested in the plan will be insufficient to pay the required benefits. A liability (or asset) must be shown in the employer's financial statements in relation to the plan and the amount of this liability or asset also has to be calculated.

Accounting for defined benefit plans in accordance with the requirements of IAS19 involves the following main steps:

- At the end of each accounting period, reliable estimates must be made of:
 - the amount of the accumulated benefits which past and present employees have earned in return for their services to date and which will be payable to them in the future ("the defined benefit obligation")
 - the extra amount of such benefits that employees have earned in return for their services during the current period (the "current service cost")

Employers are encouraged (but not required) by IAS19 to engage a qualified actuary to make the necessary estimates.

- These estimates are discounted so as to determine the present value of the defined benefit obligation and the present value of the current service cost.
- The "interest cost" for the period is calculated. This is equal to the increase during the current accounting period of the present value of the defined benefit obligation which was calculated at the end of the previous period (adjusted if part of that obligation has now been discharged as a result of benefit payments). This increase arises because the accumulated retirement benefits which employees had earned at the end of the previous period are now one period closer to being paid.
- "Actuarial gains and losses" with regard to the defined benefit obligation may now be calculated. These are caused by:
 - differences between actuarial assumptions which were made at the end of the previous period and events that actually occurred during the current period
 - changes in actuarial assumptions between the start and end of the period.
- The final step in the process is to determine the fair value of the plan assets (if any) at the end of the accounting period and to reconcile this figure with the fair value of plan assets at the start of the period

RETURN ON PLAN ASSETS: interest, dividends and other income derived from the plan assets, together with realised and unrealised gains or losses", less interest income for the period.

The defined benefit expense to be shown in the statement of comprehensive income when calculating profit or loss for an accounting period is arrived at by *adding*:

- the present value of the current service cost for the period
- interest cost for the period

and then *subtracting*:



- the amount of any employee contributions made during the period (since these have helped to fund the current service cost)
- interest income for the period.

IAS19 requires that any actuarial gains or losses and the return on plan assets (less interest income) should be shown in other comprehensive income. These amounts may not be reclassified to profit or loss in a subsequent accounting period.

The defined benefit liability (i.e. deficit) shown in the statement of financial position is equal to the present value of the defined benefit obligation at the end of the period, less the fair value of the plan assets at that date. A surplus is recognised as an asset.

IAS19 makes extensive disclosure requirements with regard to defined benefit plans. The main disclosures required are as follows:

- Information which explains the characteristics of each of the entity's defined benefit plans and the risks associated with that plan:
 - the nature of the benefits provided by the plan
 - a description of the regulatory framework within which the plan operates
 - a description of any other entity's responsibilities for governance of the plan
 - a description of the risks to which the entity is exposed because of the plan.
- Information which identifies and explains the amounts in the entity's financial statements which relate to defined benefit plan. Information which describes how the entity's defined benefit plans may affect the amount, timing and uncertainty of its future cash flow.

"Other long-term employee benefits" include items such as:

- long-term paid absences such as long-service leave and sabbatical leave
- long-term disability benefits
- profit-sharing and bonus payments

As long as these are not expected to be settled wholly before twelve months after the end of the period in which the employees render the related services. The accounting treatment of these benefits is similar to the treatment required for defined benefit post-employment plans. The employer's financial statements for an accounting period should recognise:

- a liability equal to the present value at the end of the period of the accumulated long-term benefits to which employees are entitled in return for their services to date, less the fair value of any assets out of which this obligation is to be settled
- an expense, equal to the extra amount of such benefits that employees have earned in return for their services during the current period (the current service cost) adjusted for interest cost, interest income, return on assets and actuarial gains/losses.

IAS19 does not contain any specific disclosure requirements with regard to other long-term employee benefits.

TERMINATION BENEFITS: employee benefits provided in exchange for the termination of an employee's employment.

These may arise because an entity decides to terminate an employee's employment or because of an employee's decision to accept an offer of benefits in exchange for the termination of employment.

IAS19 requires that an entity should recognise a liability and an expense for termination benefits at the earlier of the following dates:

- when the entity can no longer withdraw the offer of those benefits
- when the entity recognises costs for a restructuring that is within the scope of IAS37 and which involves the payment of termination benefits.



Termination benefits that are expected to be settled wholly before twelve months after the end of the accounting period in which they are recognised should be measured in the same way as short-term benefits (i.e. on an undiscounted basis). Otherwise, termination benefits should be measured in the same way as other long-term employee benefits.

IFRS2 - Share-Based Payment

The objective of IFRS2 *Share-based Payment* is to prescribe the accounting treatment of payments made by an entity either:

- in the form of shares (including share options), or
- in cash, where the amount of cash payable depends upon the company's share price.

It is important to distinguish between the date on which an entity and an employee agree to a share-based payment arrangement (the "grant date") and the later date on which the employee becomes entitled to receive the payment concerned (the "vesting date"). The employee will normally have to satisfy certain "vesting conditions" during the intervening period (the "vesting period") to be eligible for the payment. The main requirements of IFRS2 in relation to share-based payments to employees are as follows:

- In the case of payments which take the form of equity instruments (i.e. shares or share options) the entity should measure the fair value of each equity instrument at the grant date. Once made, this measurement is fixed and is not adjusted to reflect any changes in share values (or share option values) during the vesting period.
- It is then presumed that the employees concerned will render services to the entity during the vesting period in order to earn their share-based payments. Therefore, the cost of providing such payments is written off as an expense over that period, with a corresponding increase in equity. This will involve the use of an equity account called "shares to be issued" or something similar.
- Estimates of the number of equity instruments to be issued on the vesting date might vary during the vesting period as employees satisfy (or fail to satisfy) the vesting conditions. Such changes are accounted for prospectively in accordance with IAS8.
- Any remaining balance on the "shares to be issued" account after vesting has occurred must remain in equity (but may be transferred to another component of equity). This would occur if employees who satisfy the vesting conditions and receive share options then decide not to exercise those option

IFRS2 applies only to share-based payments made for the acquisition of goods or services. It does not apply to dividends or to the general issue of shares. Executive stock option schemes are the most common example of this type of scheme.

SHARE-BASED PAYMENT TRANSACTION: a transaction in which an entity receives goods or services in return for equity instruments or incurring a liability.

Equity instruments involve an entity issuing its shares as payment for goods or services. **It is called an equity-settled share-based payment.** The goods or services received are measured at fair value and recorded as an asset or expense; and there is corresponding increase in equity.

When incurring a liability in return for goods/services received, an entity agrees to transfer cash or other assets for amounts that are based on the price of its shares. **This is called a cash-settled share-based payment.**

Transactions in which goods or services are received as consideration for equity instruments of the entity should be measured at the fair value of the goods or services received. But, if the fair value of the goods or services cannot be measured reliably the fair value of the equity instruments granted must be used.

For transactions measured at the fair value of the goods or services received, fair value should be estimated at the date of receipt of those goods or services.

For transactions measured at the fair value of the equity instruments granted, fair value should be estimated at grant date.



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 requires:

- The counterparty to complete a specified period of service (**service condition**); the service requirement can be explicit or implicit; and/or
- Specified performance targets to be met while the counterparty is rendering the service (**performance condition**). A performance target is defined by reference to:
 - The entity's own operations (or activities) or the operations or activities of another entity in the same group (**a nonmarket condition**) or
 - 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) (**a market condition**)

IFRS 2 requires that the cost (employee expense) is charged to profit or loss:

- Immediately (at grant date) if there are no vesting conditions
- Over the vesting period (the minimum service period that must be completed by option holders) if there are vesting conditions

IFRS 2 also requires that the cost is measured as the fair value of the share options at the date of grant of the options. Market conditions that occur after the option grant date (e.g. share price changes) are not taken into account in determining the charge to profit or loss over the vesting period.

IFRS2 required disclosures include:

- The nature and extend of shared-based payments arrangements that existed during the period.
- How the fair value of the goods or services received, or the fair value of the equity instruments granted during the period, was determined.
- The effect of share-based payment transactions on the entity's profit or loss for the period and it's financial position.

Statement of Financial Accounting Standards No. 123 – Accounting for Stock- Based Compensation

Stock options come in several forms. In the most common and simplest form, a company grants options that give an employee the right - but not an obligation - to buy the company's stock at some point in the future at a predetermined purchase price.

Most options are granted with a vesting period and an expiration date. Typical vesting periods are between 3 to 5 years. Employees "earn" the right to exercise the options over the vesting period. After the expiration date, say ten years, any unexercised options would expire worthless. Assuming rational employees, no options would ever expire unless the trading price of the underlying stock was below the exercise price of the employees' stock options. When the current market price of a stock is below the option exercise price, the options are said to be "out of the money" or "under water."

Stock options also help to align shareholder and employee interests. Shareholders face a moral hazard problem because the performance of their investment depends on the decisions and actions taken by the company's employees, who act as their agents. Granting stock options to employees creates incentives for them to take decisions and undertake actions that are likely to lead to higher stock prices.

After attracting employees, vesting periods for granted options give current employees incentives to remain with the company. Employees with options that have yet to vest are less likely to leave the company because they would lose the value of the unvested options.

Accounting rules distinguish between two types of option plans: compensatory and noncompensatory. Noncompensatory plans typically take the form of employee stock purchase plans and are not primarily intended to compensate employees. Compensatory plans are those that do not qualify as noncompensatory plans. A company recognizes no compensation expense in its financial statements for noncompensatory plans, which must meet the following four criteria:

- Substantially all full-time employees may participate.



- Stock is offered to eligible employees equally or based on a uniform percentage of salary.
- The time permitted for exercise of an option or right is reasonable.
- Any discount from market price is no greater than would be reasonable in an offer of stock to stockholders or others.

Statement of Financial Accounting Standards No. 123, issued in 1995, allowed companies to continue the use of the intrinsic value method, but recommended that they use the fair value method. APB 25 required that:

- Compensation for services that a corporation receives as consideration for stock issued through employee stock option, purchase, and award plans should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay.
- Compensation cost in stock option, purchase, and award plans should be recognized as an expense of one or more periods in which an employee performs services. The grant or award may specify the period or periods during which the employee performs services, or the period or periods may be inferred from the terms or from the past pattern of grants or awards.
- Compensatory stock option plans can be either fixed or variable. Fixed plans specify both the number of shares granted and the exercise price as of the date of the grant. Therefore, the measurement date is the date of grant. Under variable option plans, either the exercise price or the effective date of the grant may change contingent on some future event. The measurement date for variable options plan is therefore indeterminate.

The difference between the quoted market price and the exercise price is referred to as each option's intrinsic value, and this method of calculating stock option compensation cost is called the intrinsic value method.

With the intrinsic value method, stock options with exercise prices equal to the fair market value of the underlying stock on the date of grant result in zero compensation expense being recorded in the financial statements. The intrinsic value of the options is calculated as zero. Almost without exception, fixed stock option plans carry exercise prices that equal the quoted market price on the date of grant. Companies record zero compensation cost, and zero amounts are recognized as expense over the vesting period.

In 1993, the FASB finally issued an exposure draft detailing proposed new accounting rules for stock options. Their draft recommended that companies treat the value of stock options just like all other types of compensation, valuing them using the fair value method and expensing these amounts in their income statements. The most notable difference between the exposure draft and APB 25 is the calculation of the value of an option. Valuing options under the intrinsic value method is easy arithmetic; valuing options under the fair value method is more complex.

The FASB's new proposal advocated that the Black-Scholes model, or other related models, be used to estimate the value of option grants. The value of the options would be recognized, as compensation cost, in the income statement over the period for which employees performed services related to the options grants.

The fair market value of an option can be calculated from mathematical models such as the Black-Scholes options pricing model. While this is a complex formula, the direction of impact of the variables that affect an option's price can be readily summarized:

Variable	Impact of increases in the variable on option value
Current price per share	Increase
Exercise price per share	Decrease
Volatility of price per share	Increase
Length of exercise period	Increase
Risk-free interest rate	Increase

The FASB believed that Black-Scholes and similar formulas enabled companies to calculate the value of options granted even when such options did not trade in public markets.

Critics of the fair value method argue that several features of employee stock options make them distinct from traded call options. First, employee stock options typically do not expire for long periods of time, such as ten years. Second, employee stock options have vesting periods. However, modern options pricing models can be



refined to incorporate the fact that such options have extended expiration periods and vesting periods. A third feature of employee stock options is that they are generally nontradable.

The FASB, at risk of achieving self-extinction, bowed to the public pressure and issued a substantially less ambitious rule. Statement of Financial Accounting Standards No. 123 encouraged the use of the fair value method of accounting for stock options but permitted companies to continue to use the intrinsic value method of APB 25. Thus SFAS 123 encouraged -but did not require - companies to account for the cost of employee stock options using the fair value method. If a company elected to continue following the intrinsic value method as set forth in APB 25, it must disclose in footnotes to the financial statements the pro forma effect fair value accounting for stock options would have had on reported earnings.

The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue -not because it believes that solution is the best way to improve financial accounting and reporting. The debate was seemingly concluded when the FASB issued the final standard in December 2004. The new standard, SFAS No. 123R - Share-Based Payment, replaced the previous standard, SFAS No. 123 - Accounting for Stock-Based Compensation. Thus, for typical December 31 year-end firms, the third quarter of 2005 was the first quarter in which stock options must be expensed. The stock option expense arising consists of both new option grants during the period as well as expense related to vesting of prior grants.

IAS32 - Financial Instruments: Presentation

IAS32 *Financial Instruments: Presentation* provides four key definitions which apply throughout all of the standards which deal with financial instruments.

FINANCIAL INSTRUMENT: any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

FINANCIAL ASSET: any asset that is:

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

FINANCIAL LIABILITY: any liability that is a contractual obligation to deliver cash or another financial asset to another entity.

EQUITY INSTRUMENT: any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Ordinary shares are the most common instance of an equity instrument.

IAS32 takes a "substance over form" approach to distinguishing between liabilities and equity. Even though the legal form of a financial instrument might be a share issue, the instrument could still be regarded as giving rise to a financial liability if the underlying substance of the transaction indicates that this is the case. IAS32 states that a financial instrument should be classified as an equity instrument if and only if the instrument includes no contractual obligation ... to deliver cash or another financial asset to another entity.

Ordinary shares are an example of an equity instrument because the company which issues the shares is under no contractual obligation to pay dividends and is usually prevented by law from repaying the share capital. Ordinary shareholders may in fact receive dividends from time to time, but the important point is that the company cannot be *required* to deliver cash or any other financial asset to these shareholders. This situation should be contrasted with a loan, where the borrower is generally obliged to make interest payments throughout the period of the loan and to repay the loan itself at the end of that period.

This approach is illustrated by the required treatment of redeemable preference shares. These are preference shares which either:

- provide for mandatory repayment of the share capital at a future date, or
- give the shareholders the right to require repayment of the share capital on or after a particular date, for a fixed or determinable amount.



In these circumstances, it is clear that the issuing company has a contractual obligation to deliver cash. Therefore, redeemable preference shares must be classified as liabilities rather than equity, despite their legal form. Furthermore, IAS32 states that interest and dividends relating to financial liabilities should be recognised as an expense when calculating the issuing company's profit or loss. Therefore, dividends paid to the holders of redeemable preference shares must be treated as an expense. Any accrued dividends unpaid at the end of an accounting period must be treated in the same way as accrued interest. Dividends that are classified as an expense are presented in the statement of comprehensive income either together with interest on other liabilities or as a separate item.

Some financial instruments (known as "compound financial instruments") contain both a liability component and an equity component. For example, loan stock that is convertible into ordinary shares at the option of the holder is a compound financial instrument. IAS32 requires that compound financial instruments should be separated into their two components and that each of these components should then be recognised separately, one as a financial liability and the other one as equity. The separation of a compound financial instrument into its two components is achieved as follows:

- the fair value of the liability component is determined first. This is equal to the fair value of a similar instrument without an associated equity component. In the case of convertible loan stocks, IAS32 states the fair value of the liability component should be determined by calculating the present value of the scheduled payments of interest and principal, ignoring the conversion option.
- The fair value of the equity component is then determined by deducting the fair value of the liability component from the fair value of the whole instrument. The fair value of the whole instrument is generally equal to the amount of the consideration which was received when the instrument was issued.

IFRS9 – Financial Instruments

The recognition and measurement rules which relate to financial assets and liabilities are located in IFRS9. The recognition rules determine when a financial asset or liability should be shown in an entity's statement of financial position. The measurement rules determine the amount at which a financial asset or liability should be carried in the financial statements.

IFRS9 states that a financial asset or a financial liability should be recognised when (and only when) the entity concerned becomes party to the contractual provisions of the instrument. In other words, recognition occurs when the financial instrument becomes binding. As regards derecognition:

- A financial asset is derecognised (removed from the statement of financial position) when the entity's contractual rights to receive cash flows from the asset expire.
- A financial liability is derecognised when the entity's contractual obligations expire or are discharged or cancelled.

IFRS9 requires that financial assets and liabilities should be measured initially at their fair value, which is normally equal to the amount of the consideration which was given or received when the asset was acquired or the liability incurred. In general, transaction costs that are directly attributable to the acquisition of a financial asset or to the issue of a financial liability should be added to the initial carrying amount of the asset or subtracted from the initial carrying amount of the liability. However, this does not apply to financial assets and liabilities which are subsequently measured at "fair value through profit or loss" (see below). Transaction costs relating to such assets and liabilities are written off as an expense when incurred.

IFRS9 classifies financial assets into three categories and then prescribes the way in which assets falling into each category should be measured after initial recognition. The three categories and the associated measurement rules are as follows:

- Financial assets at amortised cost. A financial asset falls into this category if:
 - the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest, and
 - the asset is held within a "business model" whose objective is to hold financial assets in order to collect these cash flows.

After initial recognition, such assets are measured at their amortised cost using the effective interest method (see below) and the interest calculated for each period is recognised as income when calculating the entity's



profit or loss. An example of this type of asset is a holding of loan stocks that the entity intends to hold until maturity.

- Financial assets at fair value through other comprehensive income. A financial asset falls into this category if:
 - the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest, and
 - the asset is held within a business model whose objective is achieved by both collecting these cash flows and selling financial assets. In general, this business model will involve more frequent sales of assets than in (a) above.

After initial recognition, interest is calculated using the effective interest method and recognised as income when calculating profit or loss. But changes in the asset's fair value are generally shown in other comprehensive income and are then reclassified to profit or loss when the asset is derecognised.

- Financial assets at fair value through profit or loss. This category comprises all financial assets that do not fall into either of the other two categories. After initial recognition, such assets are measured at their fair value. Changes in fair value are taken into account when calculating the entity's profit or loss. An example of a financial asset measured at fair value through profit or loss is a holding of ordinary shares. Note, however, that an entity may elect that the gains and losses arising in relation to a particular investment in an equity instrument should be recognised in other comprehensive income (as long as the instrument is not held for trading). Such gains and losses cannot subsequently be reclassified to profit or loss. Note also that an entity may designate any financial asset as "at fair value through profit or loss" if this would result in more relevant information.

The amortised cost of a financial asset is equal to the amount at which the asset was initially recognised, plus the amount of interest earned to date, minus any repayments received to date.

The effective interest method is a way of calculating the amount of interest earned to date. This method uses an interest rate that exactly discounts estimated future cash receipts to the initial carrying amount of the asset. The calculation takes into account not only interest receivable, but also items such as premiums and discounts.

If there is evidence that an impairment loss has been incurred in relation to a financial asset measured at amortised cost, IFRS9 requires that this loss should be recognised. Such a loss would arise if there is a shortfall between the cash flows that the entity was originally due to receive and the cash flows that the entity now expects to receive. In general, the amount of an impairment loss is equal to the difference between:

- the current carrying amount of the asset, and
- the present value of the future cash flows that the entity expects to receive, discounted at the effective rate of interest which was calculated at initial recognition.

When an impairment loss is recognised, the carrying amount of the asset should be reduced by the amount of the loss, either directly or through the use of an allowance account. The loss itself should be written off as an expense. In the case of trade receivables carried at original invoice amount (see above) the amount of any impairment loss is simply the difference between the current carrying amount of the receivables and the undiscounted cash flows expected to be received in relation to them.

IFRS9 requires that dividends receivable should be recognised in the calculation of an entity's profit or loss only when:

- the entity's right to receive the dividend has been established.
- it is probable that the economic benefits concerned will flow to the entity, and
- the amount of the dividend can be measured reliably.

After initial recognition, financial liabilities should usually be measured at amortised cost using the effective interest method. This is precisely the same method as is used for certain types of financial asset (see above).

There are some exceptions to this general rule, but these are mainly beyond the scope of this book. However, there are two important exceptions which must be mentioned here. These are:



- Financial liabilities at fair value through profit or loss. This category of financial liabilities is similar to the equivalent category of financial assets, and it consists mainly of financial liabilities that are held for trading. However, as with financial assets, an entity may designate any financial liability as "at fair value through profit or loss" if this would result in more relevant information. After initial recognition, financial liabilities which fall into this category should be measured at fair value. Gains or losses that arise from fluctuations in fair value are usually recognised in the calculation of the entity's profit or loss for the accounting period in which they arise. However, if a financial liability has been designated as being at fair value through profit or loss (see above) any gains or losses which are attributable to changes in the "credit risk" of the liability are recognised in other comprehensive income. Credit risk is considered later in this chapter.
- Trade payables. Short-term payables (e.g. most trade payables) may be measured at the original invoice amount if the effect of discounting is not material.

IFRS7 - Financial Instruments: Disclosures

The standard requires entities to make a number of disclosures relating to financial instruments. The purpose of these disclosures is to enable users to evaluate two things. These are:

- the significance of financial instruments for the financial position and the financial performance of the entity concerned, and
- the nature and extent of risks to which the entity is exposed in relation to financial instruments, and the way in which those risks are being managed.

Carrying amounts. The carrying amount of each category of financial asset and each category of financial liability should be disclosed either in the statement of financial position or in the notes. These categories are:

- financial assets measured at fair value through profit or loss.
- financial assets measured at fair value through other comprehensive income.
- financial assets measured at amortised cost
- financial liabilities measured at fair value through profit or loss.
- financial liabilities measured at amortised cost.

For each category of assets or liabilities measured at fair value, the disclosures should show separately the carrying amount of those assets or liabilities that the entity has chosen to designate in that category so as to provide more relevant information.

- Fair value. The fair value of each class of financial asset and liability should be disclosed in a way that facilitates comparison with carrying amounts. This disclosure is not required if the carrying amount is a reasonable approximation of fair value.
- Items of income, expense, gains, and losses. The entity should disclose the following items, either in the statement of comprehensive income or in the notes:
 - net gains or losses on each class of financial assets and liabilities (e.g. gains or losses arising from fair value fluctuations)
 - total interest income and total interest expense for financial assets and liabilities measured at amortised cost.
- Accounting policies. IFRS7 states that information about the measurement bases used for an entity's financial instruments is likely to be "material accounting policy information" and must therefore be disclosed, as required by IAS1.

IFRS7 defines three main types of risk associated with financial instruments. These are:

CREDIT RISK: the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

LIQUIDITY RISK: the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.



MARKET RISK: the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices". Market prices may change because of changes in exchange rates ("currency risk"), changes in market interest rates ("interest rate risk") or for other reasons ("other price risk").

In general, IFRS7 requires entities to disclose information which enables the users of the financial statements to evaluate the nature and extent of any risks arising from financial instruments to which the entity is exposed at the end of the reporting period. For each type of risk, this information should include:

- the exposures to risk and the way in which they arise.
 - the methods used to measure the risk
 - the entity's policies and processes for managing the risk.
 - quantitative data about the exposure to risk at the end of the reporting period.
- Credit risk. For each class of financial instrument, the entity should disclose:
 - the amount of the maximum exposure to credit risk (before taking account of any collateral held as security)
 - a description of any collateral held as security.
 - quantification of the extent to which this collateral mitigates the credit risk.
 - Liquidity risk. The entity should disclose a maturity analysis for financial liabilities, and a description of how any inherent liquidity risk is managed.
 - Market risk. The entity should disclose a sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period. This analysis should show how profit or loss and equity would be affected by changes in the relevant risk variable.

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