

FINANCIAL ACCOUNTING AND REPORTING

ACCOUNTING PROCESS

Steps in the Accounting Cycle – There are 9 basic steps in the accounting cycle, which includes 2 phases known as recording and summarizing.

RECORDING PHASE

1. **Analyzing the transaction (business document)**- This is where the accountant gathers information from source documents and determines the impact of the transaction on the financial position as represented by the equation "assets equals liabilities plus equity".
2. **Journalizing** – This is the process of recording the transactions in the appropriate journals. A journal is a chronological record of transactions also known as the **book of original entry**. Although all transactions *could be recorded* in the **general journal**, it is more efficient to use special journals in recording a large number of like transactions. Special journals that enterprises usually use are:
 1. **Sales Journal** – Only sales of merchandise on account are recorded.
 2. **Cash receipts journal** – All types of cash receipts are recorded.
 3. **Purchase journal** – Used to record all purchases on account (merchandise, equipment and supplies).
 4. **Cash disbursement journal** – All payments of cash for any purpose are recorded.

Type of journal entries according to form:

1. Simple journal entry – One which contains a single debit and a single credit element.
2. Compound journal entry – One which has two or more elements and often representing two or more transactions.

Accounts are the storage units of accounting information and used to summarize changes in assets, liabilities and equity including income and expenses. The following are a broad classification of kinds of accounts:

1. Real account – Statement of financial position or so called permanent accounts. These accounts are not closed and carryover to the next accounting period. (ex. Cash, AR and PPE)
 2. Nominal account – Income statement or temporary capital accounts. These accounts are closed at the end of the accounting period. (ex. Sales and expenses)
 3. Mixed account – A combination of real and nominal accounts. (ex. Prepaid expenses)
 4. Clearing account – Holds temporarily certain information pending transfer to other ledger accounts.
 5. Controlling account – The general ledger account that summarizes the detailed information in a subsidiary ledger.
 6. Suspense account – Is an account that holds temporarily certain information pending for disposition.
 7. Reciprocal account – Has a counterpart in another book with in the entity or in another ledger or another entity.
 8. Principal account – An account that is independent or can stand alone.
 9. Auxiliary account – An account that cannot stand alone and are technically neither assets, liabilities nor income and expenses.
 10. Summary account
3. **Posting** - It is the process of transferring data from the journal to the appropriate accounts in the general ledger and subsidiary ledger. This process classifies all accounts that were recorded in the journals.

Kinds of ledgers

1. General ledger – Includes all the accounts appearing on the financial statements.
2. Subsidiary ledgers – Affords additional detail in support of certain general ledger accounts.

SUMMARIZING PHASE

- 4. **Preparing the unadjusted trial balance** – A list of general ledger accounts with their respective debit or credit balance. The purpose of the unadjusted trial balance is to provide evidence that the total debits in the general ledger equal the total credits and prepares the accounts for adjustments.
- 5. **Preparing adjusting entries** – To take up accruals, expiration of prepayments and deferrals, estimations and other events often not signaled by new source documents. Adjusting entries are made at the end of each accounting period. The concepts involved behind adjusting entries are ACCRUAL, MATCHING OF COSTS AGAINST REVENUE and ACCOUNTING PERIOD.

Typical Adjusting Entries classified according to timing of cash flow.

- 1. **Prepayments and Deferrals** – The cash flow precedes the revenue or the expense recognition.

Prepaid Expenses					
Asset Method			Expense Method		
Prepaid expense (asset)	xx		Expense	xx	
Cash		xx	Cash		xx
Adjustment:					
Expense	xx		Prepaid expense (asset)	xx	
Prepaid expense		xx	Expense		xx

Deferred or Unearned Revenue					
Liability Method			Income Method		
Cash	xx		Cash	xx	
Unearned Income (liab.)		xx	Income		xx
Adjustment:					
Unearned Income	xx		Income	xx	
Income		xx	Unearned Income (liab.)		xx

- 2. **Accruals** – Income or expense recognition precedes the cash flow.
 - a. Accrued Income – Income earned but not yet received. A receivable is always debited and income is recognized (credited)
 - b. Accrued expenses – Expenses incurred but not yet paid. An expense is recognized (debited) and a liability is always credited.
- 3. **Estimates** – Adjusting entries that do not involve cash flows.
 - a. Doubtful accounts – The expense to be matched against credit sales.
 - b. Depreciation - Allocation of the cost of fixed assets as expense over its useful life
- 4. **Ending inventory** - An adjustment to set up the year-end physical count of the inventory. This only applies if the PERIODIC INVENTORY SYSTEM IS USED.
- 6. **Preparing the financial statements** – The most important part of the summarizing phase, this is where the processed information is communicated to external users.

Basic financial statements

- a. Statement of financial position
- b. Income statement or a statement of comprehensive income
- c. Statement of changes in equity
- d. Statement of cash flows
- e. Notes and disclosures

- 7. **Preparing the closing entries** – Recorded and posted for the purpose of closing all nominal or temporary accounts to the **income summary account** and the resulting net income or loss is afterwards closed to the **capital or retained earnings account**.
- 8. **Preparing the post closing trial balance** – A listing of general ledger accounts and their balances after closing entries have been made. The post closing trial balance is the same with the year-end statement of financial position, the only difference is that valuation accounts like allowances for assets are found in the credit side instead of being deducted from the related asset account.
- 9. **Preparing reversing entries** – The last and optional step in the accounting cycle. Reversing entries are made at the beginning of the new accounting period to reverse **certain adjusting entries** from the succeeding accounting period.

The purpose of reversing entries is a matter of convenience for accruals and consistency for the adjustments in the following year for prepaid expenses and deferred income when the **income statement method** was used to record the cash flow.

Once again, reversing entries will only apply to the following but remember that they are not necessary and only optional:

- 1. **Accrued income**
- 2. **Accrued expense**
- 3. **Prepaid expense, only** if the **expense method** was used in recording the payment
- 4. **Unearned income, only** if the **income method** was used in recording the collection

Accrued Income	Prepaid expense (Exp. Method)
12 mos. rental at 100 per month beginning Nov. 1, 2016. 12/31/16 Adjustment: Rent Receivable200 Rent Income200 1/1/2017 Reversing entry: Rent Income200 Rent Receivable200	18 mos. rental at 100 per month beginning Nov. 1, 2016 11/1/2016 Rent Expense1,800 Cash1,800 12/31/2016 Adjustment: Prepaid Rent1,600 Rent Expense1,600
After the reversal, the rent receivable account will have a balance of ZERO and the rent income account will have a DEBIT balance of 200. Hence the collection of 1,200 will be recorded as follows:	The adjustment under the expense method will be for the unused portion or the prepayment of 1,600 . If the asset method was used, the adjustment would have been for 200 or the portion for the expense.
10/31/2017 Cash1,200 Rent Income1,200	1/1/2017 Reversing entry: Rent Expense1,600 Prepaid Rent1,600 After the reversing entry, the 1600 is once again expensed and the 12/31/2017 adjusting entry will be as follows: Prepaid rent400 Rent Expense400 If the reversing entry was not prepared, the adjustment would have been a debit to Rent expense and credit to prepaid rent for 1,200 which is the adjustment used if the ASSET METHOD was used.

END

FINANCIAL ACCOUNTING AND REPORTING

The Conceptual Framework for Financial Reporting**PURPOSE AND STATUS OF THE FRAMEWORK**

The IASB Framework for the Preparation and Presentation of Financial Statements describes the **basic concepts** by which financial statements are prepared. The Framework **serves as a guide** to the FRSC in developing accounting standards and as a guide to resolving accounting issues that are not addressed directly in Philippine Accounting Standards or Philippine Financial Reporting Standards or Interpretations. The purpose of the framework as outlined is to:

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

This *Conceptual Framework* is **not an IFRS** and hence does not define standards for any particular measurement or disclosure issue.

Scope of the Framework:

- The **Objective of general purpose financial reporting**;
- **Qualitative characteristics** of financial information
- **Underlying assumption**
- **The definition, recognition and measurement of the elements of the financial statements**
- Concepts of **capital and capital maintenance**.

The Objective of Financial Reporting

- The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.
- General purpose financial reports provide information about the financial position of a reporting entity, which is information about the entity's economic resources and the claims against the reporting entity. Financial reports also provide information about the effects of transactions and other events that change reporting entity's economic resources and claims.

Financial performance reflected by accrual accounting

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

Qualitative Characteristics of Useful Financial Information

These characteristics are the attributes **that make the information in financial statements useful** to investors, creditors, and others. The Framework identifies “**fundamental**” and “**enhancing**” qualitative characteristics:

Fundamental Characteristics

Relevance - Information in financial statements is relevant when it is capable of making a difference in the decisions made by the users.

Ingredients of relevance:

- **Predictive Value** – Information can help users increase the likelihood of correctly predicting or forecasting the outcome of certain events.
- **Feedback Value** – Information can help users confirm or correct earlier expectations.

Note that the predictive and confirmatory roles of information are interrelated.

Materiality - Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.

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

Ingredients of Faithful Representation

- **Complete** - A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.
- **Neutral** - A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users
- **Free from error** means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process.

Enhancing qualitative characteristics

Comparability, verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

- **Comparability** is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items.
- **Verifiability** - helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.
- **Timeliness** - means having information available to decision-makers in time to be capable of influencing their decisions.
- **Understandability** - Classifying, characterising and presenting information clearly and concisely makes it *understandable*.

The cost constraint on useful financial reporting

Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information. There are several types of costs and benefits to consider.

Underlying Assumptions (Postulates)

The Framework sets **Going Concern** as the only underlying assumption **meaning**, financial statements presume that an enterprise will continue in operation indefinitely or, if that presumption is not valid, disclosure and a different basis of reporting are required.

The new FRSC conceptual framework mentions going concern as the only underlying assumption (previously **Accrual** was included). However, it is widely believed that inherent traits of the financial statements are the basic assumptions of:

- **Accounting Entity.** The business is separate from the owners, managers, and employees who constitute the business. Therefore transactions of the said individuals should not be included as transactions of the business.
- **Time Period.** Financial reports are to be prepared for one year or a period of twelve months.
- **Monetary unit.** There are two aspects under this assumption
 - a. **Quantifiability of the peso**, meaning that the elements of the financial statements should be stated under one unit of measure which is the Philippine Peso.
 - b. **Stability of the peso**, means that there is still an assumption that the purchasing power of the peso is stable or constant and that instability is insignificant and therefore ignored.

The Elements of Financial Statements

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements.

The elements directly related to **financial position** and their **definition according to the framework** are:

- **Asset-** A resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.
- **Liability-** A present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
- **Equity-** The residual interest in the assets of the enterprise after deducting all its liabilities.

The elements directly related to **performance** and their **definition according to the framework** are:

- **Income-** Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
- **Expense-** Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Recognition of the Elements of Financial Statements

Recognition **is the process of incorporating** in the financial statements an item that meets the **definition of an element and satisfies the following criteria for recognition:**

- It is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
- The item's cost or value can be measured with reliability.

Based on these general criteria:

- **An asset** is recognized in the statement of financial position when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost or value that can be measured reliably.
- **A liability** is recognized in the statement of financial position when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.
- **Income** is recognized in the when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities
- **Expenses** are recognized when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets.

Measurement of the Elements of Financial Statements

Measurement involves **assigning monetary amounts** at which the elements of the financial statements are to be recognized and reported. The Framework acknowledges that a variety of measurement bases are used today to different degrees and in varying combinations in financial statements, including:

- **Historical cost**
- **Current cost**
- **Net realizable (settlement) value**
- **Present value (discounted)**

Historical cost is the measurement basis most commonly used today, but it is usually combined with other measurement bases. The Framework does not include concepts or principles for selecting which measurement basis should be used for particular elements of financial statements or in particular circumstances. The qualitative characteristics do provide some guidance in this matter.

Concepts of Capital

- **Financial concept of capital** - capital is synonymous with net assets of the enterprise. This is the concept of capital adopted by most enterprises. A financial concept of capital, e.g. invested money or invested purchasing power, means capital is the net assets or equity of the entity.
- **Physical concept of capital** – capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

Concepts of Capital Maintenance

- **Financial capital maintenance** – Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the of the period exceeds the financial (or money) amount of the net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.
- **Physical capital maintenance** – Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise (or the resources need to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

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Presentation of Financial Statements (PAS 1)

Objective

- Prescribe the basis for **presentation of general purpose financial statements**, to **ensure comparability** both with the entity's financial statements of previous periods and with the financial statements of other entities.
- Overall framework and responsibilities for the presentation of financial statements.
- Guidelines for their structure and minimum requirements for the content of the financial statements.
- Standards for recognizing, measuring, and disclosing specific transactions are addressed in other Standards and Interpretations.

Scope

- Applies to all general purpose financial statements, that are based on Philippine Financial Reporting Standards.
- General purpose financial statements are those intended to serve users who do not have the authority to demand financial reports tailored for their own needs.

Purpose of Financial Statements

The objective of general purpose financial statements is to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions. To meet that objective, financial statements provide information about an entity's:

- **Assets.**
- **Liabilities.**
- **Equity.**
- **Income and expenses, including gains and losses.**
- **Other changes in equity.**
- **Cash flows.**

That information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

Components of Financial Statements - A complete set of financial statements comprises:

- 1) A statement of financial position as at the end of the period
- 2) A statement of comprehensive income for the period
- 3) A statement of changes in equity for the period
- 4) A statement of cash flows for the period
- 5) Notes, comprising a summary of significant accounting policies and other explanatory information
- 6) A statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

Overall Considerations for Statement Presentation

Fair Presentation and Compliance with PFRSs

The financial statements must "present fairly" the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of PFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

PAS 1 requires that an entity whose financial statements comply with PFRSs **make an explicit and unreserved statement of such compliance in the notes**. Financial statements shall not be described as complying with PFRSs unless they comply with all the requirements of PFRSs.

Inappropriate accounting policies **are not rectified** either by disclosure of the accounting policies used or by notes or explanatory material.

PAS 1 acknowledges that, in extremely rare circumstances, management may conclude that compliance with an PFRS requirement would be so misleading that it would conflict with the objective of financial statements set out in the Framework. In such a case, the entity is required to depart from the PFRS requirement, with detailed disclosure of the nature, reasons, and impact of the departure.

Going Concern

An entity preparing PFRS financial statements is presumed to be a going concern. If management has significant concerns about the entity's ability to continue as a going concern, the uncertainties must be disclosed. If management concludes that the entity is not a going concern, the financial statements should not be prepared on a going concern basis, in which case PAS 1 requires a series of disclosures.

Accrual Basis of Accounting

PAS 1 requires that an entity prepare its financial statements, **except** for cash flow information, using the accrual basis of accounting.

Consistency of Presentation

The presentation and classification of items in the financial statements **shall be retained** from one period to the next **unless a change is justified** either by a change in circumstances or a requirement of a new PFRS.

Materiality and Aggregation

Each material class of similar items must be presented separately in the financial statements. Dissimilar items may be aggregated only if they are individually immaterial.

Offsetting

Assets and liabilities, and income and expenses, **may not be offset** unless required or permitted by a Standard or an Interpretation.

Comparative Information

PAS 1 requires that comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements, both face of financial statements and notes, unless another Standard requires otherwise. If comparative amounts are changed or reclassified, various disclosures are required.

Frequency of Reporting

There is a presumption that financial statements will be prepared **at least annually**. If the annual reporting period changes and financial statements are prepared for a different period, the enterprise must disclose the reason for the change and a warning about problems of comparability.

Statement of Financial Position

Current/Noncurrent Distinction

An entity must normally present a classified statement of financial position, separating current and noncurrent assets and liabilities. Only if a presentation based on liquidity provides information that is reliable and more relevant may the current/noncurrent split be omitted.

Current assets

An entity shall classify an asset as current when:

- (a) It expects to realize the asset, or intends to sell or consume it, in its normal operating cycle
- (b) It holds the asset primarily for the purpose of trading
- (c) It expects to realize the asset within twelve months after the reporting period
- (d) The asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current.

Normal Operating Cycle – The time between the acquisition of assets for processing and their realization cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months.

Current liabilities

An entity shall classify a liability as current when:

- (a) It expects to settle the liability in its normal operating cycle
- (b) It holds the liability primarily for the purpose of trading
- (c) The liability is due to be settled within twelve months after the reporting period
- (d) The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period

An entity shall classify all other liabilities as non-current.

Issues on Refinancing

- An entity classifies its financial liabilities as current when they are due to be settled within twelve months after the end of the reporting period, even if:
 - a. The original term was for a period longer than twelve months; and
 - b. The intention is supported by an agreement to refinance, or reschedule the payments, on a long-term basis is **completed after** the end of the reporting period and completed before the financial statements are authorized for issue.
- If the entity has the discretion to refinance, or to roll over the obligation for at least twelve months after the end of the reporting period under an existing loan facility, it classifies the obligation as non-current, even if it would be due within a shorter period.

Breach of a Loan Covenant

- If a liability has become payable on demand because an entity has breached an undertaking under a long-term loan agreement on or before the end of the reporting period, **the liability is current, even if the lender has agreed, after the end of the reporting period and before the authorization of the financial statements for issue, not to demand payment as a consequence of the breach. However, the liability is classified as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least 12 months after the end of the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.**

Statement of comprehensive income

An entity shall present all items of income and expense recognized in a period:

- (a) In a single statement of comprehensive income, or
- (b) In two statements: a statement displaying components of profit or loss (separate income statement) and a second statement beginning with profit or loss and displaying components of other comprehensive income (statement of comprehensive income).

Components of Comprehensive Income

1. Profit and Loss - Income minus Expenses including Tax expense and any Income or Loss from Discontinued Operations.

2. Other Comprehensive income – Items of income and expenses including reclassification adjustments (RA) that are not included in Profit and Loss as required by a standard or interpretation. There are two types of OCI items, those that are reclassified to profit or loss (RA) and those that are reclassified to Retained Earnings (RE). OCI includes the following
- Unrealized gain or loss on equity investments measured at FVOCI (RE)
 - Unrealized gain or loss on debt investments measured at FVOCI (RA)
 - Unrealized gain or loss from derivative contracts designated as cash flow hedge (RA)
 - Revaluation Surplus (RE)
 - Remeasurement Gains and losses for defined benefit plans (RE)
 - Change in fair value arising from credit risk for financial liabilities measured at FVPL (RE)
 - Translation gains and losses of foreign operations

Information to be presented in the statement of comprehensive income

As a minimum, the statement of comprehensive income shall include line items that present the following amounts for the period:

- (a) Revenue
- (b) Finance costs
- (c) Share of the profit or loss of associates and joint ventures accounted for using the equity method
- (d) Tax expense
- (e) A single amount comprising the total of:
 - (i) The post-tax profit or loss of discontinued operations and
 - (ii) The post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation
- (f) Profit or loss
- (g) Each component of other comprehensive income **classified by nature**
- (h) Share of the other comprehensive income of associates and joint ventures accounted for using the equity method
- (i) Total comprehensive income.

An entity shall disclose the following items in the statement of comprehensive income as allocations of profit or loss for the period:

- (a) Profit or loss for the period attributable to:
 - (i) Minority interest, and
 - (ii) Owners of the parent.
- (b) Total comprehensive income for the period attributable to:
 - (i) Minority interest, and
 - (ii) Owners of the parent.

- An entity shall present either an analysis of expenses using a classification based on either the **nature of expenses or their function** with in the entity, whichever provides information that is reliable and more relevant.

- a. **Nature of expense method** – Expenses are aggregated in the income statement according to their nature and are not reallocated among various functions within the entity.

Revenue		X
Other income		X
Changes in inventories of finished goods and work in progress	X	
Raw materials and consumables used	X	
Employee benefit costs	X	
Depreciation and amortization	X	
Other expense	<u>X</u>	
Total expense		<u>(X)</u>
Profit		<u>X</u>

- b. **Function of expense or cost of sales method** – Classifies expenses according to their function as part of cost of sales or, for example, the cost of distribution or administrative activities.

Revenue	X
Cost of sales	<u>(X)</u>
Gross profit	X
Other income	X
Distribution costs	<u>(X)</u>
Administrative expenses	<u>(X)</u>
Other expenses	<u>(X)</u>
Income before tax	X
Income tax expense	<u>(X)</u>
Net income	<u>X</u>

- An entity shall **not present** any items of **income and expense as extraordinary items**, either on the face of the income statement or in the notes

Statement of Changes in Equity

An entity shall present a statement of changes in equity showing in the statement:

- Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to minority interest
- For each component of equity, the effects of retrospective application or retrospective restatement recognized in accordance with PAS 8
- The amounts of transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners
- For each component of equity, reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing each change.

An entity shall present, either in the statement of changes in equity or in the notes, the amount of dividends recognized as distributions to owners during the period, and the related amount per share.

Statement of Cash Flows

Cash flow information provides users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilize those cash flows.

Notes to the Financial Statements

The notes must:

- a. Present information about the basis of preparation of the financial statements and the specific accounting policies used;
- b. Disclose any information required by PFRSs that is not presented on the face of the statement of financial position, income statement, statement of changes in equity, or statement of cash flows
- c. Provide additional information that is not presented on the face of the statement of financial position, income statement, statement of changes in equity, or statement of cash flows that is deemed relevant to an understanding of any of them.

Notes should be cross-referenced from the face of the financial statements to the relevant note. The notes should normally be presented in the following order:

- a. A statement of compliance with PFRSs
- b. A summary of significant accounting policies applied, including:
 - a. The measurement basis (or bases) used in preparing the financial statements; and
 - b. The other accounting policies used that are relevant to an understanding of the financial statements.
- c. Supporting information for items presented on the face of the statement of financial position, income statement, statement of changes in equity, and statement of cash flows, in the order in which each statement and each line item is presented.
- d. Other disclosures, including:
 - a. Contingent liabilities and unrecognized contractual commitments
 - b. Non-financial disclosures, such as the entity's financial risk management objectives and policies.

Disclosure of judgments - an entity must disclose, in the summary of significant accounting policies or other notes, the judgments, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognized in the financial statements.

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FINANCIAL ACCOUNTING AND REPORTING

ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

1. Accounting Policies

- **Accounting policies** are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.
 - An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless a Standard or an Interpretation specifically requires or permits categorization of items for which different policies may be appropriate.
 - If a Standard or an Interpretation requires or permits such categorization, an appropriate accounting policy shall be selected and applied consistently to each category.

Change in Accounting Policy – A change from one acceptable accounting policy to another acceptable accounting policy. If the change is from an unacceptable accounting policy it shall be treated as a correction of an error.

- Cases or circumstances to change accounting policy:
 - a. Is required by a standard or interpretation; or
 - b. Results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance, or cash flows.
 - c. Note that changes in accounting policies **do not include** applying an accounting policy to a kind of transaction or event that did not exist in the past. Neither is a change from a accounting principle that is not acceptable to one that is acceptable a change in accounting policy.

- **Treatment of Changes in Accounting Policies**

By applying the transitional provision if the change is either required by a standard or interpretation or Retrospective Application

Retrospective application means adjusting the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as *if the new accounting policy had always been applied*.

- However, if it is impracticable to determine either the period, specific effects or the cumulative effect of the change for one or more prior periods presented, the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, **which may be the current period**, and shall make a corresponding adjustment to the opening balance of each affected component of equity for that period.
- Also, if it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity shall adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.

2. Changes in Accounting Estimate

- **A change in accounting estimate** is an adjustment of the carrying amount of an asset or liability, or related expense, resulting from reassessing the expected future benefits and obligations associated with that asset or liability.
- Accounting estimates result from uncertainties inherent in business activities that many items cannot be measured with accuracy but can only be estimated. Examples of which are bad debts rate, factors used in computing for depreciation and warranty obligations.
- Changes in accounting estimates are normal and recurring changes that is necessary if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience.
- The effect of a change in an accounting estimate shall be recognized **prospectively** by including it in profit or loss in:
 - The period of the change, if the change affects that period only; or
 - The period of the change and future periods, if the change affects both.
- However, to the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it is recognized by adjusting the carrying amount of the related asset, liability, or equity item in the period of the change.
- When it is difficult to distinguish the change is in accounting policy from a change in accounting estimate, the change is treated as a change in accounting estimate.

3. Errors

- **Prior period errors** are omissions from, and misstatements in, an entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that was available and could reasonably be expected to have been obtained and taken into account in preparing those statements. Such errors result from mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.
- The general principle in PAS 8 is that an entity must correct all material prior period errors **retrospectively** in the first set of financial statements authorized for issue after their discovery by:
 - Restating the comparative amounts for the prior period(s) presented in which the error occurred; or
 - If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.
 - However, if it is impracticable to determine the period-specific effects of an error on comparative information for one or more prior periods presented, the entity must restate the opening balances of assets, liabilities, and equity for the earliest period for which retrospective restatement is practicable (which may be the current period).
 - Further, if it is impracticable to determine the cumulative effect, at the beginning of the current period, of an error on all prior periods, the entity must restate the comparative information to correct the error prospectively from the earliest date practicable.

Disclosures Relating to Prior Period Errors

- Disclosures relating to prior period errors include:
 - The nature of the prior period error
 - For each prior period presented, to the extent practicable, the amount of the correction:
 - For each financial statement line item affected
 - For basic and diluted earnings per share (only if the entity is applying PAS 33)
 - The amount of the correction at the beginning of the earliest prior period presented
 - If retrospective restatement is impracticable, an explanation and description of how the error has been corrected.
- Financial statements of subsequent periods need not repeat these disclosures.

- - END - -

FINANCIAL ACCOUNTING AND REPORTING

OPERATING SEGMENTS

Scope

PFRS 8 applies to the separate or individual financial statements of an entity (and to the consolidated financial statements of a group with a parent):

- Whose debt or equity instruments are traded in a public market
- That files, or is in the process of filing, its (consolidated) financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market.

However, when both separate and consolidated financial statements for the parent are presented in a single financial report, segment information need be presented only on the basis of the consolidated financial statements.

Identifying an Operating Segment

- An operating segment must be a **component of an entity**, meaning, its operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.
- It 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)
- Whose operating results are regularly reviewed by the entity's **chief operating decision maker** to make decisions about resources to be allocated to the segment and assess its performance
- For which discrete financial information is available.

An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

The term '**chief operating decision maker**' identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity.

Reportable Segment – An operating Segment for which segment information is required to be disclosed

QUANTITATIVE THRESHOLDS

An entity shall **report separately** information about an operating segment that meets any or at least one of the following quantitative thresholds:

- a) Its reported **revenue**, including both sales to external customers and intersegment sales or transfers, is 10 percent or more of the combined revenue, internal and external, of all operating segments.
- b) The absolute amount of its reported **profit or loss** is 10 percent or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating segments that reported a loss.
- c) Its **assets** are 10 percent or more of the combined assets of all operating segments.

Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

OVERALL SIZE TEST

- If total external revenue attributable to reportable segments identified using the 10% quantitative thresholds is **less than 75% of the total consolidated or enterprise revenue (external revenue)**, additional segments should be identified as reportable segments, even if they **do not meet** the 10 % requirement. Until at least 75% of total consolidated or enterprise revenue is included in reportable segments.
- In other words, the quantitative thresholds will not be necessary in determining additional reportable segments in order to meet the 75% requirement.

DISCLOSURES REQUIRED FOR REPORTABLE SEGMENTS

An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates. Disclosures will include

- a) General information - Factors used to identify the entity's reportable segments, including the basis of organization and types of products and services from which each reportable segment derives its revenues.
- b) Information about reported segment profit or loss
- c) Reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material segment items to corresponding entity amounts

ENTITY WIDE DISCLOSURES:

- a) Information about products and services
- b) Information about geographical areas
- c) Information about **major customers** - If revenues from transactions with a **single external customer** amount to 10 per cent or more of an entity's revenues, the entity shall disclose that fact and disclose the following:
 - a. The **total amount of revenues** from each such customer
 - b. The **identity of the segment or segments** reporting the revenues.

-- END --

FINANCIAL ACCOUNTING AND REPORTING

INTERIM REPORTING

Key Definitions

Interim Period – Is a financial reporting period shorter than a full financial year.

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**.

Minimum Components of an Interim Financial Report

- a. Condensed statement of financial position
- b. Condensed income statement
- c. Condensed statement showing either (i) all changes in equity or (ii) changes in equity other than those arising from capital transactions with owners and distributions to owners
- d. Condensed statement of cash flows
- e. **Selected** explanatory notes

Required information in Condensed Statements

- a. Headings and subtotals included in most recent annual financial statements
- b. Selected minimum explanatory notes - explaining events and transactions significant to an understanding of the changes in financial position/performance since last annual reporting date
- c. Selected line items or notes if their omission would make the condensed financial statements misleading
- d. Basic and diluted earnings per share (if applicable) on the face of statement of comprehensive income.

General Guidelines of Interim Financial Reporting

- a. Revenues from products sold or services rendered are generally recognized for interim reports on the **same basis as for the annual period**.
- b. Expenses **associated directly with revenue** are matched against revenue in those interim periods in which the related revenue is recognized.
- c. Expenses **not associated** with revenue are recognized **in the** interim periods as incurred or **allocated** over the interim periods benefited.
- d. Inventories are measured for interim financial reporting by the same principles as at financial year-end (LCNRV). However full inventory taking may not be required at interim dates although it must be done at financial year-end. It may be sufficient to make estimates at interim dates based on sales margin.
- e. Inventory losses from **permanent market declines** are recognized in the interim period in which the decline occurs. Recoveries of such losses on the same inventory in later interim period should be recognized as gains in later interim periods.
- f. Temporary market declines on inventories and recoveries at a later interim period **are now recognized** for interim purposes.
- g. Interim period income tax expense should reflect the same general principles of income tax accounting applicable to annual reporting.

- h. Gains or losses from, disposal of property, gains or losses from sale of discontinued operations and other gains and losses **should not be allocated** over the interim periods.

Other Guidelines

Accounting Policies

- Principles for recognizing assets, liabilities, income and expenses are same as in the most recent annual financial statements, unless there is a change in an accounting policy that is to be reflected in the next annual financial statements.
- Tax recognised based on weighted average annual income tax rate expected for the full year
- Tax rate changes during the year are adjusted in the subsequent interim period during the year.

USE OF ESTIMATES - Interim reports require a greater use of estimates than annual reports.

COSTS INCURRED UNEVENLY - Anticipated or deferred only if it would be possible to defer or anticipate at yearend.

SEASONAL, CYCLICAL OR OCCASIONAL REVENUE

- Revenue received during the year should not be anticipated or deferred where anticipation would not be appropriate at year end
- Recognized as it occurs.

Periods to be presented

- Statement of financial position as at the end of the current interim period (e.g. 30 Sept. 2016) and as of the end of the immediately preceding financial year (e.g. 31 December 2015)
- Statements of comprehensive income for the current interim period (e.g. July – Sept. 2016) and cumulatively for the current financial year (Jan. – Sept. 2016) (which will be the same for half year ends), with comparatives for the interim period of the preceding financial year (Jan. – Sept. 2015)
- Statements of changes in equity for the current financial year to date, with comparatives for the year to date of the immediately preceding financial year
- Statements of cash flows for the current financial year to date, with comparatives for the year to date of the immediately preceding financial year.

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FINANCIAL ACCOUNTING AND REPORTING

EVENTS AFTER THE REPORTING PERIOD

Key Definitions

Events after the reporting period: An event, which could be favorable or unfavorable, that occurs between the reporting period and the date that the financial statements are authorized for issue.

Adjusting event: An event after the reporting period that provides further evidence of conditions that existed at the end of the reporting period, including an event that indicates that the going concern assumption in relation to the whole or part of the enterprise is not appropriate.

Non-adjusting event: An event after the reporting period that is indicative of a condition that arose after the reporting period.

Adjusting event

Examples:

- Events that indicate that the going concern assumption in relation to the whole or part of the entity is not appropriate
- Settlement after reporting date of court cases that confirm the entity had a present obligation at reporting date
- Bankruptcy of a customer that occurs after reporting date that confirms a loss existed at reporting date on trade receivables
- Sales of inventories after reporting date that give evidence about their net realisable value at reporting date
- Determination after reporting date of cost of assets purchased or proceeds from assets sold, before reporting date
- Discovery of fraud or errors that show the financial statements are incorrect.

Non-adjusting event

Examples:

- Major business combinations or disposal of a subsidiary
- Major purchase or disposal of assets, classification of assets as held for sale or expropriation of major assets by government
- Destruction of a major production plant by fire after reporting date
- Announcing a plan to discontinue operations
- Announcing a major restructuring after reporting date
- Major ordinary share transactions
- Abnormal large changes after the reporting period in assets prices or foreign exchange rates
- Changes in tax rates or tax law
- Entering into major commitments such as guarantees
- Commencing major litigation arising solely out of events that occurred after the reporting period.

Accounting

- **Adjust financial statements for adjusting events** – events after the reporting period that provide further evidence of conditions that existed at the end of the reporting period, including events that indicate that the going concern assumption in relation to the whole or part of the enterprise is not appropriate.
- **Do not adjust for non-adjusting events** – events or conditions that arose after the reporting period.

- If an entity declares dividends after the reporting period, the entity shall not recognize those dividends as a liability at the reporting period. That is a non-adjusting event.

Going Concern Issues Arising After Reporting period

An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

Disclosure

- Non-adjusting events should be disclosed if they are of such importance that non-disclosure would affect the ability of users to make proper evaluations and decisions. The required disclosure is (a) the nature of the event and (b) an estimate of its financial effect or a statement that a reasonable estimate of the effect cannot be made.
- A company should update disclosures that relate to conditions that existed at the reporting period to reflect any new information that it receives after the reporting period about those conditions.
- Companies must disclose the date when the financial statements were authorized for issue and who gave that authorization. If the enterprise's owners or others have the power to amend the financial statements after issuance, the enterprise must disclose that fact.

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FINANCIAL ACCOUNTING AND REPORTING

RELATED PARTY DISCLOSURES**Objective of PAS 24**

The objective of PAS 24 is to ensure that an entity's financial statements **contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected** by the existence of related parties and by transactions and outstanding balances with such parties.

Related Parties

Parties are considered to be related if one party has the ability to control the other party or to exercise significant influence or joint control over the other party in making financial and operating decisions. **A party is related to an entity if:**

- (a) Directly, or indirectly through one or more intermediaries, the party:
 - (i) Controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries)
 - (ii) Has an interest in the entity that gives it significant influence over the entity
 - (iii) Has joint control over the entity
- (b) The party is an associate of the entity
- (c) The party is a joint venture in which the entity is a venturer
- (d) The party is a member of the key management personnel of the entity or its parent;
- (e) The party is a **close member of the family of any individual referred to in (a) or (d)**. They may include
 - a. The individual's domestic partner and children
 - b. Children of the individual's domestic partner
 - c. Dependants of the individual or the individual's domestic partner
- (f) The party is an entity that is controlled, jointly controlled or significantly influenced by or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e)
- (g) The party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

The following are not necessarily related parties

- Two enterprises simply because they have a director or key manager in common
- Two venturers who share joint control over a joint venture
- Providers of finance, trade unions, public utilities, government departments and agencies in the course of their normal dealings with an enterprise
- A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.

Related Party Transactions - Is a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged.

Disclosures

Relationships between parents and subsidiaries

- Regardless of whether there have been transactions between a parent and a subsidiary, an entity must disclose the name of its parent and, if different, the ultimate controlling party.
- If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so must also be disclosed.

Management Compensation - Disclose key management personnel compensation in total and for each of the following categories:

- Short-term employee benefits
- Post-employment benefits
- Other long-term benefits
- Termination benefits
- Equity compensation benefits.

Key management personnel are those persons having authority and responsibility for planning, directing, and controlling the activities of the entity, directly or indirectly, including all directors (whether executive or otherwise).

Related party transactions - If there have been transactions between related parties, disclose the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. These disclosures would be made separately for each category of related parties and would include:

- The amount of the transactions.
- The amount of outstanding balances, including terms and conditions and guarantees.
- Provisions for doubtful debts related to the amount of outstanding balances.
- Expense recognized during the period in respect of bad or doubtful debts due from related parties.

Examples of the Kinds of Transactions that Are Disclosed If They Are with a Related Party

- Purchases or sales of goods.
- Purchases or sales of property and other assets.
- Rendering or receiving of services.
- Leases.
- Transfers of research and development.
- Transfers under license agreements.
- Transfers under finance arrangements (including loans and equity contributions in cash or in kind).
- Provision of guarantees or collateral.
- Settlement of liabilities on behalf of the entity or by the entity on behalf of another party

A statement that related party transactions were made on terms equivalent to those that prevail in arm's length transactions should be made only if such terms can be substantiated.

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FINANCIAL ACCOUNTING AND REPORTING

CASH AND CASH EQUIVALENTS

CASH – In accounting, cash includes money in the form of currency and coins, negotiable instruments in the form of checks and money orders acceptable by the bank for immediate credit and bank deposits whether in a savings or current account.

CASH EQUIVALENTS – Under PAS 7, cash equivalents are short-term and highly liquid investment that are readily convertible into cash and so near their maturity that they present insignificant risk in changes in value because of changes in interest rates.

BANK RECONCILIATION - A statement that settles the difference between the bank statement balance and the cash balance per book which is the current balance in the checkbook of the depositor.

BOOK RECONCILING ITEMS – Includes credit memos, debit memos and errors that need to be corrected or adjusted by the depositor in order for the balance per book to reconcile with the adjusted balance.

BANK RECONCILING ITEMS – Includes deposits in transit, outstanding checks and errors.

CERTIFIED CHECKS – Checks that have been accepted by the bank and where the drawer's account has been debited but the money has yet to be withdrawn by the payee. The funds are now held by the bank on behalf of the payee and the check is no longer outstanding.

PETTY CASH FUND – Money set aside to pay small and recurring expenses where it will be inefficient to settle such payments by issuing checks. Accounting for petty cash involves an Imprest Fund System that is more commonly used due to its efficiency and convenience rather than the Fluctuating Fund System that requires each disbursement to be recorded.

IMPREST CONTROL SYSTEM – Implemented as a control system where all cash receipts is including checks to be deposited intact and all cash disbursements be made by the issuance of a check. Although a petty cash fund will also be used to settle small expenses.

Cash includes the following items plus adjustments:

- Undeposited currency and coins
- Checks and money orders held unless the checks are post-dated, defective or stale. Such items shall still be included as receivables.
- Unrestricted bank deposits, however checks that have been recorded as payments that have not been delivered or post-dated must be restored back to the bank deposits' balance with a corresponding liability for the payment that was made.
- Funds on hand and deposits that are for current use and have been restricted for a liability that is classified as "current". This includes petty cash fund, payroll fund and funds for taxes and dividends as mentioned in PAS 1.

Special Items of Cash

- A. **Bank Overdraft** – A credit or negative balance in the bank account of the depositor resulting from an issuance of a check that exceeds the amount of the deposit.
 - As a rule an overdraft shall be classified as a current liability and not offset against current accounts with a positive or debit balance.
 - As an exception, if the overdraft is in a bank where there are other accounts that have a positive balance and those accounts are sufficient to cover the overdraft, the total cash shall be shown net of the overdraft.

B. **Compensating Balance Agreement** – Part of or deposits that a bank can use to offset an existing loan. However, compensating balances can also describe a minimum amount of the deposit that a depositor agrees to maintain in order to guarantee future credit availability.

- In the case of deposits that a bank can use to offset a loan, the assumption is that this amount is legally restricted to withdrawal and therefore excluded from cash, however in cases that it still remains to be unrestricted, the compensating balance shall be part of cash. If the compensating balance is legally restricted the following rules shall be followed:
 - a) The related loan is short-term: The compensating balance shall be part of current assets but separately from cash.
 - b) The related loan is long-term: The compensating balance is part of noncurrent assets as an investment.
- An informal agreement to maintain a minimum amount of deposit will not be legally restricted and therefore included in cash.

C. **Time Deposits** – Bank savings account that earns interest but not subject to immediate withdrawal or check issuance. A notice must be submitted by the depositor for the withdrawal of funds and interest earned shall be forfeited.

- Time deposits are excluded from cash because of their restriction on availability as funds and are classified as investments and shall follow these specific classifications:
 - a. Cash equivalents if the original term is 3 months or less.
 - b. Short term investments if the original term is more than 3 months to 1 year
 - c. Long-term investments if the original term is more than 1 year.

Cash Equivalents – The three important characteristics for cash equivalents as mentioned in PAS 7 are short-term, highly liquid and near maturity. In other words, short-term debt instruments with low risk (also low yield) and acquired 3 months or less from maturity date shall be considered as cash equivalents.

Examples include Treasury Bills, Bonds and Notes, Time Deposits, Certificate of deposits and Bankers Acceptances and Commercial Papers.

Example of Adjusted Balance Reconciliation

	<u>Bank</u>		<u>Book</u>
Unadjusted Balance	X	Unadjusted Balance	X
Deposit in transit	+	Credit memo*	+
Outstanding checks	(-)	Debit memo**	(-)
Errors	<u>+/(-)</u>	Errors	<u>+/(-)</u>
Adjusted balance	<u>X</u>	Adjusted balance	<u>X</u>

*Credit memos include collections by the bank; interest credited by the bank and matured time deposits transferred to the current account.

**Debit memos include NSF checks, bank service charges and authorized bank debits.

E N D

FINANCIAL ACCOUNTING AND REPORTING

RECEIVABLES

A **receivable** is the right to receive cash, another asset (goods) or services

Receivables may be current or noncurrent and trade or nontrade

- The rules on current and noncurrent classification are discussed in detail under PAS 1 and are also based on the receivable as either trade or nontrade
- Trade receivables arise from the **sale of goods or services to customers** and in the form of accounts receivable or notes receivable while nontrade receivables are receivables from **all other types** of transactions like advances to officers and employees and advances to other entities.

Accounts receivable arise from credit sales. The amount to be recorded as accounts receivable from sales on account shall be the “Invoice Price” which is the amount after deducting trade discounts from the List Selling Price. Take note that trade discounts are not accounted for and are ignored for recording purposes.

Example: An item is sold to a credit customer under terms of 2/15 and net 30, FOB shipping point terms with a list selling price of P2,000,000 with trade discounts of 20% and 10%. The Invoice price is computed as follows:

List selling price	2,000,000
Less: 20% trade discount	<u>400,000</u>
Net	1,600,000
Less: 10% trade discount	<u>160,000</u>
Invoice price	<u>1,440,000</u>

As mentioned the entry will not include the total trade discount of P560,000 (400,000 + 160,000) but instead only the P1,440,000 amount will be recorded as follows:

Accounts Receivable	1,440,000	
Sales		1,440,000

The following transactions also affect accounts receivable in computing for the ending balance:

ACCOUNTS RECEIVABLE	
+ Credit Sales	(-) Sales returns and allowances
+ Recovery of accounts written off	(-) Sales discounts
	(-) Collections including recovery
	(-) Write off
	(-) Factored accounts

The **write off** for accounts receivable under the allowance method is recorded by:

Allowance for doubtful accounts	xx	
Accounts Receivable		xx

So therefore the **recovery or the collection** on an accounts receivable that already has been written off cannot be recorded by simply debiting cash and crediting accounts receivable. The entry for the write off must be reversed and before recording the collection with the following two entries:

Accounts Receivable	xx	
Allowance for doubtful accounts		xx
Allowance for doubtful accounts	xx	
Accounts Receivable		xx

Combining the two entries will be more efficient by:

Cash	xx
Allowance for doubtful accounts	xx

The ending balance of accounts receivable shall be presented as part of current assets under the heading of “trade and other receivables” at the Net Realizable Value (expected cash value) or “amortized cost”

The net realizable shall be computed after deducting an allowance for the following:

- Sales returns – Value of merchandise expected to be returned by customers as a result in error of deliveries and defects
- Sales discounts – Value of price savings to customers expected to pay within the discount period and take advantage of the cash discount.
- Freight charges – Amount of freight charges collected by the shipper from the buyer even though the shipment was under FOB destination terms. This amount shall not be remitted by the buyer hence deducted from the receivable.
- Doubtful accounts – Allowance for expected uncollectability that is an inherent risk from selling on credit.

Allowance Method vs. Direct Write-off Method

	<u>Allowance</u>	<u>Direct Write-off</u>
Application	Generally Accepted	Non-GAAP
Accounts considered doubtful	Expense and Increase the Allowance	Not accounted for
Write-off	Debit Allowance and Credit AR	Debit expense and Credit AR
Recovery	Debit AR and credit Allowance	Debit AR and credit expense

The computation for the doubtful accounts expense which is an adjusting entry and the allowance for doubtful accounts will be as follows:

Beginning balance	X
Write off	(X)
Recovery	<u>X</u>
Balance before adjustment	X
Doubtful accounts expense	<u>X</u>
Ending balance	<u>X</u>

There are 3 methods in estimating doubtful accounts:

- 1) The **percentage of net credit sales** method which will provide the amount of doubtful accounts expense for the year and therefore is a method that emphasizes proper matching of doubtful accounts against sales. This amount will then be added to the balance before adjustment, the total of the two will then be the amount of allowance at yearend or after adjustment.
- 2) The **percentage of accounts receivable** method will provide the amount of required allowance for doubtful accounts and just like its counterpart the “Aging Method”, the amount of doubtful accounts expense will be worked back as an adjustment to the amount of required allowance.
- 3) The **Aging of accounts receivable** method that is arguably the most accurate of all three methods since an analysis is made and each classification of accounts receivable is multiplied by a specific rate of the estimate of uncollectability. Naturally older accounts receivable are more likely to be uncollectible compared to newer or more recent sales.

RECEIVABLE FINANCING

Accelerating the collection of receivables either by using accounts receivable as a loan collateral, selling the receivables without recourse and discounting of notes receivable.

The use of receivables as a loan collateral can either be an designated as a pledging of accounts receivable or an assignment of accounts receivables.

Pledging	Assignment
➤ Total or all of the accounts receivable is used. ➤ A disclosure is made of the fact that receivables have been pledged. ➤ The accounts receivable is accounted for normally but are not reclassified. ➤ Accounting for the loan shall be made with respect to the proceed, recording of interest and payment of the principal.	➤ A specific portion or specific accounts receivable are used a collateral. Not all of the accounts receivable balance. ➤ A reclassification is made on the assigned accounts. ➤ Disclosure on the “equity on the assigned accounts or of the assignor” is disclosed in the notes. ➤ The equity in the assigned accounts is the difference between the balance of the assigned accounts and the balance of the loan.
➤ The absolute sale of receivables is known as factoring and can be either a “casual factoring” transaction or “factoring as a continuing agreement”.	

Casual factoring is a sale of the receivables at a discount. This is similar to any type of sale of an asset in order to generate cash quickly. However the sale is always made below the carrying amount or the net realizable value of the accounts receivable and therefore a loss shall be recognized as follows:

Face value of AR		X
Less: Service fee or commissions		<u>X</u>
Selling price		X
Less: Accounts receivable	X	
Allowances	<u>X</u>	<u>X</u>
Loss on factoring		<u>X</u>

Factoring as a continuing agreement involves the sale of accounts receivable to a financing entity on a long term basis and where the buyer is committed to buy the receivables before the actual goods are sold to the customers on credit. In other words, the collection and credit responsibilities are surrendered to the buyer as soon as goods are delivered to the customers. The following items shall be deducted from the face value of the receivables:

Face value of AR		X
Less: Service fee or commissions	X	
Interest charges	X	
Factor’s holdback	<u>X</u>	<u>X</u>
Proceeds from factoring		<u>X</u>

Both the service fee and interest shall be recognized as an expense, meanwhile the factor’s holdback is a receivable and a value where the factor shall deduct the sales discounts and sales returns taken by the seller’s customers before finally remitting to the seller the balance when all of the accounts receivable is collected.

Discounting of notes receivable that is with recourse and on a notification basis shall involve the following computation:

Face value or principal	X
Interest on maturity	<u>X</u>
Maturity value	X
Less: Discount (MV x DR x remaining term)	<u>X</u>
Proceeds from discounting	<u>X</u>

The discount rate shall be determined by the bank buying the note, however if there is no discount rate provided, the same rate on the note shall be used as the discount rate. The remaining term is also known as the “discount period”.

The total receivable shall also be computed on the date of the discounting which is the face value plus the accrued interest from the date of the note. This amount shall then be compared with the proceeds of the discounting and a “loss” shall be recognized for the difference.

The entry for the discounting shall be as follows:

Cash	xx
Loss on discounting	xx
Notes receivable discounted	xx
Interest income or interest receivable	xx

The note receivable discounted account is credited rather than writing off the notes receivable account because of the contingent liability feature of the discounting transaction. However, this account shall be a contra-asset account and deducted from the total notes receivable to be presented in the statement of financial position.

Valuation or the Carrying Amount of Notes Receivable

- Notes receivable shall be presented at its present value or the discounted value of its cash flows.
- As a rule, if the note is interest bearing and the interest rate is a realistic interest rate, the face value of the note shall be its present value. An exception to this rule is that noninterest bearing notes shall not be discounted if they are short term. Although there is still a difference between the face value and the present value, the discount is deemed to be immaterial and therefore computing for the present value shall not be necessary.
- Therefore, it shall be for both noninterest bearing and long term notes where it will be necessary to discount the cash flows in order to present the notes at their present value. However, even if a note is interest bearing but if the interest rate is unreasonably low, it will be necessary to compute for the present value of the cash flows which will include the future interest computed on the low interest rate.
- If the note is a term note, the present value of 1 concept shall be applied, if the note is an installment note and the installments and intervals are equal, the present value of an ordinary annuity shall be used.
- The 12 month collection period shall also be applied to determine if it's a current asset or non current asset. However, the present value shall be the amount to be presented, hence the related discount shall be deducted from the face value of the note representing the cash flow.

Loan Impairment Loss – Both PFRS 9 and US GAAP requires the assessment of the collectability of a loan receivable and whenever circumstances and present information and events indicate that it will be probable that any portion of the principal and interest agreed upon will not be collected an allowance for the present value of cash flows that will not be collected shall be recognized. The computation corresponding entry shall be as follows:

PV of expected cash flows	X	
Less: Face value	X	
Accrued interest	X	<u>X</u>
Loan impairment loss		<u>(X)</u>
Loan impairment loss		xx
Interest receivable		xx
Allowance for loan impairment		xx

The interest receivable shall be written off if interest income already recognized shall not be realized meanwhile the allowance shall be deducted from the current balance of the notes receivable.

END

FINANCIAL ACCOUNTING AND REPORTING

INVENTORIES

Key Terms and Definitions

- **Inventories are assets:**
 - (a) Held for sale in the ordinary course of business;
 - (b) In the process of production for such sale; or
 - (c) In the form of materials or supplies to be consumed in the production process or in the rendering of services.
- **Net realizable value** is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.
- **Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Cost of Inventories

- Costs of purchase
- Costs of conversion
- Other costs **incurred in bringing the inventories to their present location and condition.**

Costs of Purchase

- The costs of purchase of inventories comprise the purchase price, import duties and other **non recoverable** taxes and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

Costs of Conversion

- **Direct labor**
- **Variable production overhead** is allocated to each unit using the actual use of production facilities.
- **Fix production overhead** allocated using the normal operating capacity of production facilities.

Other Costs

- Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories **to their present location and condition**. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

Inventory cost *should exclude*:

- Abnormal waste
- Storage costs
- Administrative overheads unrelated to production
- Selling costs
- Foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency
- Interest cost when inventories are purchased with deferred settlement terms.

Cost Formulas

- The cost of inventories of items that are **not ordinarily interchangeable** and goods or services produced and **segregated for specific projects** shall be assigned by using **specific identification** of their individual costs.
- The cost of inventories, other than those that are not ordinarily interchangeable, shall be assigned by using the **first-in, first-out (FIFO) or weighted average cost formula**. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

FIFO Perpetual and Periodic Illustrated

		Units	Unit Cost	Total Cost
Jan. 1	Beginning balance	8,000	70.00	560,000
6	Purchase	3,000	81.00	243,000
Feb. 5	Sale	10,000		
Mar. 5	Purchase	11,000	73.50	808,500
Mar. 8	Purchase return	800	73.50	58,800
Apr. 10	Sale	7,000		
Apr. 30	Sale return	300		

- If periodic FIFO is used, the ending inventory will be unit cost from the March 8 purchase and will be deducted from the accumulation of the beginning inventory and net purchase, known as the total goods available for sale.

Beginning balance (8,000 x 70)	560,000
Feb. 5 Purchase (3,000 x 81)	243,000
Mar. 5 Net Purchase (10,200 x 73.50)	749,700
Total goods available for sale	1,552,700
Less: Ending Inventory* (4,500 x 73.50)	330,750
Cost of goods sold	1,221,950
*Ending inventory in units (21,200 – 16,700)	4,500

- **COGS computation under perpetual**

Feb. 5 Costs of goods sold:	
Jan. 1 Inventory (8,000 x 70)	560,000
Jan. 6 Inventory (2,000 x 81)	162,000
Total	722,000
April 10 Net Costs of goods sold:	
Jan.6 Inventory (1,000 x 81)	81,000
Mar. 5 Inventory (5,700 x 73.50)	418,950
Total	499,950

Jan. 1 Inventory	560,000
6 Purchase	243,000
Total	803,000
Feb. 5 COGS	(722,000)
Balance	81,000
Mar. 5 Net Purchase	749,700
Total	830,700
Apr. 10 Net COGS	(499,950)
Apr. 30 Inventory balance	330,750

➤ Periodic Average or Weighted Average

Beginning balance (8,000 x 70)	560,000
Feb. 5 Purchase (3,000 x 81)	243,000
Mar. 5 Net Purchase (10,200 x 73.50)	749,700
Total goods available for sale	1,552,700
Less: Ending Inventory* (4,500 x 73.24**)	329,580
Cost of goods sold	1,223,120
 Total cost	 1,552,700
Divide by total number of units	21,200
**Weighted average cost per unit	73.24

➤ Perpetual Average or Moving Average

Jan. 1 Inventory	560,000
6 Purchase	243,000
Total	803,000
Feb. 5 COGS (10,000 x 73.00***)	(730,000)
Balance	73,000
Mar. 5 Net Purchase	749,700
Total	822,700
Apr. 10 Net COGS (6,700 * 73.46****)	(492,182)
Apr. 30 Inventory balance	330,518
 *** Feb 5. Average cost (803,000 / 11,000)	 73.00
**** April 10 Average cost (822,700 / 11,200)	73.46

Measurement of Inventories

- Inventories are required to be stated at the **lower of cost and net realizable value (NRV)**. Inventories are usually written down to net realizable value item by item. In some circumstances, however, it may be appropriate to group similar or related items.

EXAMPLE:

	<u>Cost</u>	<u>NRV</u>	<u>LCNRV</u>
Product A	200,000	180,000	180,000
Product B	300,000	250,000	250,000
Product C	100,000	130,000	100,000
Total	600,000	560,000	530,000

- The total carrying amount of inventories shall be 530,000, which is the most conservative amount by applying the LCNRV approach.

Write-Down to Net Realizable Value

- If the ending inventory is recorded outright at 530,000, the writedown shall be immediately recognized in cost of goods sold. This is the **direct or cost of sales method**.
- If the ending inventory is recorded first at the cost of 600,000, a loss of 70,000 with a corresponding credit to an allowance account shall be recognized. This is the **loss/allowance method**.
- Any write-down to NRV should be recognized as an expense in the period in which the write-down occurs.
- Any reversal should be recognized in the income statement in the period in which the reversal occurs.

Recognition as an Expense

- When inventories are sold, the carrying amount of those inventories shall be recognized as

an expense in the period in which the related revenue is recognized.

- The amount of any write-down of inventories to net realizable value and all losses of inventories shall be recognized as an expense in the period the write-down or loss occurs.
- The amount of any reversal of any write-down of inventories, arising from an increase in net realizable value, shall be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.
- Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognized as an expense during the useful life of that asset.

Required disclosures:

- Accounting policy for inventories.
- Carrying amount, generally classified as merchandise, supplies, materials, work in progress, and finished goods. The classifications depend on what is appropriate for the enterprise.
- Carrying amount of any inventories carried at fair value less costs to sell.
- Amount of any write-down of inventories recognized as an expense in the period.
- Amount of any reversal of a writedown to NRV and the circumstances that led to such reversal.
- Carrying amount of inventories pledged as security for liabilities.
- Cost of inventories recognized as expense (cost of goods sold).

Inventory Estimation Techniques

- **Gross Method** – Based on the assumption that the gross profit applied by an entity to its products remains approximately the same from period to period and therefore the relationship between cost of goods sold and sales is constant.

Goods available for sale		X
Less: Estimated cost of goods sold		
Net sales*	X	
Less: Gross profit	<u>X</u>	<u>X</u>
Estimated ending inventory		<u>X</u>

The cost of goods sold can also be computed if the net sale is multiplied by 1 less the GP rate if the gross profit rate **based on sales** or net sales divided by 1 plus the gross profit rate if the gross profit rate is **based on cost**.

*Net sales shall be gross sales less “sales returns and allowance” or “sales returns” only in order for the estimate in ending inventory **not to be overstated**.

- **Retail Method** – Employed by retailers dealing with numerous different items for sale with varying mark up percentages to keep track unit cost.

Goods available for sale at retail		X
Less: Net sales	X	
Employee discounts	X	
Normal losses	<u>X</u>	<u>X</u>
Estimated ending inventory		<u>X</u>
Multiplied by the cost ratio		<u>%</u>
Estimated ending inventory at cost		<u>X</u>

- Conservative Cost Ratio = GAS at cost divided by GAS at retail before net markdown
- Average Cost Ratio = GAS at cost divided by GAS at retail (after net markdown)
- FIFO Cost Ratio = Purchases at cost divided by Purchases at retail after net markdown
- **Net sales** similar to the “gross profit method” of estimation is computed by ignoring the sales discount and sales allowance if it is separated from sales returns.

-- END --

FINANCIAL ACCOUNTING AND REPORTING

PAS 41 - AGRICULTURE

Objective of PAS 41

The objective of PAS 41 is to establish standards of accounting for agricultural activity -- the management of the biological transformation of biological assets (living plants and animals) into agricultural produce (harvested product of the enterprise's biological assets).

Key Definitions:

- **Agricultural activity** is the management by an entity of the biological transformation of biological assets for sale, into agricultural produce, or into additional biological assets.
- **Agricultural produce** is the harvested product of the entity's biological assets.
- A **biological asset** is a living animal or plant.
- **Biological transformation** comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset.
- A **group of biological assets** is an aggregation of similar living animals or plants.
- **Harvest** is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.
- **Bearer plant** is a living plant that:
 - a. Is used in the production process of agricultural produce,
 - b. Is expected to bear produce for more than one period
 - c. Has a remote likelihood of being sold (except as part of incidental scrap sales).

Initial Recognition

An enterprise should recognize a biological asset or agriculture produce only when the enterprise controls the asset as a result of past events, it is probable that future economic benefits will flow to the enterprise, and the fair value or cost of the asset can be measured reliably.

Measurement

- Biological assets should be measured on initial recognition and at subsequent reporting dates at **fair value less costs of disposal**, unless fair value cannot be reliably measured.
- Agricultural produce should be measured at **fair value less costs of disposal** at the point of harvest. Because harvested produce is a marketable commodity, there is no 'measurement reliability' exception for produce.
- The gain on initial recognition of biological assets at fair value, and changes in fair value of biological assets during a period, are reported in net **profit or loss**.
- A gain on initial recognition of agricultural produce at fair value should be included in net profit or loss for the period in which it arises.
- All costs related to biological assets that are measured at fair value are recognized as expenses when incurred, other than costs to purchase biological assets.
- **Bearer plants** are accounted for under PAS 16 using the cost model, or the revaluation model. Before bearer plants are able to bear agricultural produce (i.e. before maturity), they are accounted for as self-constructed items of property, plant and equipment. The agricultural produce of the bearer plant remains within the scope of PAS 41 and is therefore accounted for at fair value.
- PAS 41 presumes that fair value can be reliably measured for most biological assets. However, that presumption can be rebutted for a biological asset that, at the time it is initially recognized in financial statements. In such a case,
- The asset is measured at cost less accumulated depreciation and impairment losses if the asset does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are determined to be clearly inappropriate or unworkable.

- But the enterprise must still measure all of its other biological assets at fair value. If circumstances change and fair value becomes reliably measurable, a switch to fair value less disposal costs is required.

Measurement of fair value

- A quoted market price in an active market for a biological asset or agricultural produce is the most reliable basis for determining the fair value of that asset. If an active market does not exist, PAS 41 provides guidance for choosing another measurement basis. First choice would be a market-determined price such as the most recent market price for that type of asset, or market prices for similar or related assets; if reliable market-based prices are not available, the present value of expected net cash flows from the asset should be used, discounted at a current market-determined pre-tax rate.
- In limited circumstances, cost is an indicator of fair value, where little biological transformation has taken place or the impact of biological transformation on price is not expected to be material.
- The fair value of a biological asset is based on current quoted market prices and is not adjusted to reflect the actual price in a binding sale contract that provides for delivery at a future date.

Other Issues

- a. The change in fair value of biological assets is part **physical change** (growth, etc.) and **part unit price change**. Separate disclosure of the two components is encouraged, not required.
- b. Fair value measurement **stops at harvest**. PAS 2, Inventories, applies after harvest.
- c. Agricultural land is accounted for under PAS 16, Property, Plant and Equipment. However, biological assets that are physically attached to land are measured as biological assets separate from the land.
- d. Intangible assets relating to agricultural activity (for example, milk quotas) are accounted for under PAS 38, Intangible Assets.
- e. Unconditional government grants received in respect of biological assets measured at fair value are reported as income when the grant becomes receivable.

Disclosure requirements in PAS 41 include:

- Carrying amount of biological assets
- Description of an enterprise's biological assets, by broad group
- Change in fair value during the period
- Fair value of agricultural produce harvested during the period
- Description of the nature of an enterprise's activities with each group of biological assets and non-financial measures or estimates of physical quantities of output during the period and assets on hand at the end of the period
- Information about biological assets whose title is restricted or that are pledged as security
- Commitments for development or acquisition of biological assets
- Financial risk management strategies
- Methods and assumptions for determining fair value
- Reconciliation of changes in the carrying amount of biological assets, showing separately changes in value, purchases, sales, harvesting, business combinations, and foreign exchange differences

Disclosure of a quantified description of each group of biological assets, distinguishing between consumable and bearer assets or between mature and immature assets, is encouraged but not required. If fair value cannot be measured reliably, additional required disclosures include:

- Description of the assets
- An explanation of the circumstances
- If possible, a range within which fair value is highly likely to fall
- Gain or loss recognized on disposal
- Depreciation method
- Useful lives or depreciation rates
- Gross carrying amount and the accumulated depreciation, beginning and ending

If the fair value of biological assets previously measured at cost now becomes available, certain additional disclosures are required.

Disclosures relating to government grants include the nature and extent of grants, unfulfilled conditions, and significant decreases in the expected level of grants.

FINANCIAL ACCOUNTING AND REPORTING

INVESTMENTS IN ASSOCIATES

Key Definitions

- **Associate**- Is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.
- **Significant influence** - Is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.
- **Equity method** - Is a method of accounting whereby the investment is initially recognized at cost and adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The profit or loss of the investor includes the investor's share of the profit or loss of the investee.

Identification of Associates

- A holding of 20% or more of the voting power (directly or through subsidiaries) will indicate significant influence unless it can be clearly demonstrated otherwise.
- If the holding is **less than 20%**, the investor will be presumed **not to have significant influence** unless such influence can be clearly demonstrated.
- The existence of significant influence by an investor is usually evidenced in one or more of the following ways:
 - a) Representation on the board of directors or equivalent governing body of the investee;
 - b) Participation in the policy-making process;
 - c) Material transactions between the investor and the investee;
 - d) Interchange of managerial personnel; or
 - e) Provision of essential technical information.

Accounting for Associates

- In its consolidated financial statements, an investor **should use the equity method** of accounting for investments in associates, unless:
 - a. An investment in an associate that is acquired and held exclusively with a view to its disposal within 12 months from acquisition should be accounted for as held for trading under **PFRS 9 (FVPL)**.
 - b. A parent that is exempted from preparing consolidated financial statements by PAS 27 may prepare separate financial statements as its primary financial statements. Use cost method or PFRS 9.
 - c. An investor need not use the equity method if all of the following four conditions are met:
 1. The investor is itself a wholly owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method;
 2. The investor's debt or equity instruments are not traded in a public market;
 3. The investor did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and
 4. The ultimate or any intermediate parent of the investor produces consolidated financial statements available for public use that comply with PFRS.

Applying the Equity Method of Accounting

1. **Basic principle** – The equity investment is **initially recorded at cost** and is subsequently adjusted to reflect the investor's share of the **net profit or loss of the associate**.
2. **Distributions and other adjustments to carrying amount** - Distributions received from the investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be required arising from **OTHER changes** in the investee's equity (revaluation surplus and translation gains and losses).
3. **An associate with outstanding preference shares**
 - a. The investor computes its share of profits or losses after adjusting for the dividends on such shares, **whether or not the dividends** have been declared on **cumulative preference shares**.
 - b. However if the preference shares is **non-cumulative**, adjustments for dividends are made only if there is a declaration.

4. **Implicit goodwill and fair value adjustments** - On acquisition of the investment any difference between the cost of the investment and the **investor's share of the net fair value** of the associate's identifiable assets, liabilities and contingent liabilities is accounted for in accordance with PFRS 3 *Business Combinations*. Therefore:
 - (a) Goodwill relating to an associate is included in the carrying amount of the investment. However, **amortization of that goodwill is not permitted** and is therefore not included in the determination of the investor's share of the associate's profits or losses.
 - (b) Any excess of the investor's share of the net fair value of the associate's identifiable assets, liabilities and contingent liabilities over the cost of the investment
 - Is **excluded** from the carrying amount of the investment
 - **Included as income in the determination of the investor's share of the associate's profit or loss in the period in which the investment is acquired.**
 - This is more commonly known as "negative goodwill" or the "gain on bargain purchase"
5. **Appropriate adjustments** to the investor's share of the profits or losses after acquisition are made to account for additional depreciation of the associate's depreciable assets based on the excess of their fair values over their carrying amounts at the time the investment was acquired. This rule also applies to inventories since this will have an effect in the associate's reported net income.
6. **Transactions with associates**
 - Unrealized profits and losses resulting from upstream (associate to investor) and downstream (investor to associate) transactions should be eliminated to the extent of the investor's interest in the associate if the asset sold between the associate and investor has not yet been sold to an unrelated party.
 - However, realized profits and losses shall be recognized once the asset is sold to an unrelated party or if the asset is being consumed through depreciation.
7. **Discontinuing the equity method** - Use of the equity method should cease from the date that **significant influence ceases**.
 - The difference between the selling price and carrying amount of the investment sold shall be recognized in profit or loss.
 - The "retained investment" shall be accounted for under PFRS 9 and shall be remeasured to fair value on the date significant influence ceases and recognized in profit or loss.
8. **Application of the equity method achieved in stages**
 - The previously held interest that was accounted for under the cost or fair value method shall be remeasured to fair value on the date the investor gains significant influence.
 - The difference between the fair value and the carrying amount of the previously held investment shall be recognized in profit or loss.
 - The total of the fair value of the previously held investment and the new acquisition cost shall be regarded as the total cost of the investment classified as "associate".
 - If the FVOCI was used to account for the previously held investment, any cumulative unrealized gain or loss as OCI shall be reclassified to retained earnings.
9. **Date of associate's financial statements**
 - The investor should use the financial statements of the associate as of the same date as the financial statements of the investor unless it is impracticable to do so.
 - If it is impracticable, the most recent available financial statements of the associate should be used, with adjustments made for the effects of any significant transactions or events occurring between the accounting period ends.
 - However, the difference between the reporting date of the associate and that of the investor **cannot be longer than three months**.
9. **Losses in excess of investment**
 - The investor's share in the associate's losses cannot exceed the "interest in the associate" and shall discontinue the application of the equity method if this is the case.
 - After the investor's interest is reduced to zero, additional losses are recognized by a provision (liability) only to the extent that the investor has incurred legal or constructive obligations or made payments on behalf of the associate.
 - If the associate subsequently reports profits, the investor resumes recognizing its share of those profits only after its share of the profits equals the share of losses not recognized.

- - END - -

FINANCIAL ACCOUNTING AND REPORTING

INVESTMENT PROPERTY

Definition of Investment Property

Investment property Land or a building or part of a building or both held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both.

Examples of investment property:

- a. Land held for long-term capital appreciation
- b. Land held for undecided future use
- c. Building leased out under an operating lease
- d. Vacant building held to be leased out under an operating lease
- e. Property under construction as investment property

The following are **not investment property** and, therefore, are outside the scope of PAS 40:

- a. Property held for use in the production or supply of goods or services or for administrative purposes (Property, plant and equipment)
- b. Property held for sale in the ordinary course of business or in the process of construction of development for such sale (Inventories)
- c. Property being constructed or developed on behalf of third parties (Construction Contracts)
- d. Owner-occupied property (Property, Plant and Equipment), including property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees and owner-occupied property awaiting disposal
- e. Property leased to another entity under a finance lease.

Other Classification Issues

Property held under an operating lease

A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property provided that:

- The rest of the definition of investment property is met
- The operating lease is accounted for as if it were a finance lease in accordance with PAS 17 Leases
- The lessee uses the fair value model set out in this Standard for the asset recognized.
- An entity may make the foregoing classification on a property-by-property basis.

Partial own use - If the owner uses part of the property for its own use, and part to earn rentals or for capital appreciation

- If the portions can be sold or leased out separately, they are accounted for separately. Therefore the part that is rented out is investment property.
- If the portions cannot be sold or leased out separately, the property is investment property only if the owner-occupied portion is insignificant.

Ancillary services - If the enterprise provides ancillary services to the occupants of a property held by the enterprise, the appropriateness of classification as investment property is determined by the significance of the services provided.

- If those services are a relatively insignificant component of the arrangement as a whole (for instance, the building owner supplies security and maintenance services to the lessees), then the enterprise may treat the property as investment property.
- Where the services provided are more significant (such as in the case of an owner-managed hotel), the property should be classified as owner-occupied.

Intracompany rentals - Property rented to a parent, subsidiary, or fellow subsidiary

- **Not investment property in consolidated financial statements** that include both the lessor and the lessee, because the property is **owner-occupied** from the perspective of the group.
- However, such property could qualify as **investment property in the separate financial statements** of the lessor, if the definition of investment property is otherwise met.

Recognition

- Investment property should be recognized as an asset
 - a. When it is probable that the future economic benefits that are associated with the property will flow to the enterprise
 - b. The cost of the property can be reliably measured.

Initial measurement

- Investment property is initially measured at cost, **including transaction costs**.
- Such cost **should not include** start-up costs, abnormal waste, or initial operating losses incurred before the investment property achieves the planned level of occupancy.

Measurement subsequent to initial recognition - After initially recognizing the investment property at cost, an enterprise may choose between the

- Fair value model
- Cost model
- **One method** must be adopted for all of an entity's investment property. Change is permitted only if this results in a more appropriate presentation. PAS 40 notes that this is highly unlikely for a change from a fair value model to a cost model.

Fair value model

- a. Investment property is **remeasured at fair value**, which is the amount for which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction. **Gains or losses** arising from changes in the fair value of investment property must be included in **net profit or loss** for the period in which it arises.
- b. Fair value should reflect the actual market state and circumstances as of the end of the reporting period. The best evidence of fair value is normally given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other contracts. In the absence of such information, the entity may consider current prices for properties of a different nature or subject to different conditions, recent prices on less active markets with adjustments to reflect changes in economic conditions, and discounted cash flow projections based on reliable estimates of future cash flows.
- c. There is a rebuttable presumption that the enterprise will be able to determine the fair value of an investment property reliably on a continuing basis. However, if, in exceptional circumstances, an entity follows the fair value model but at acquisition concludes that a property's fair value is not expected to be reliably measurable on a continuing basis, the property is accounted for in accordance with the benchmark treatment under PAS 16, Property, Plant and Equipment (cost less accumulated depreciation less accumulated impairment losses).
- d. Where a property has previously been measured at fair value, it should continue to be measured at fair value until disposal, even if comparable market transactions become less frequent or market prices become less readily available.

Cost Model

- a. After initial recognition, investment property is accounted for in accordance with the cost model as set out in PAS 16, Property, Plant and Equipment – cost less accumulated depreciation and less accumulated impairment losses.

Transfers to or from Investment Property Classification

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

- Commencement of owner-occupation (transfer from investment property to owner-occupied property)
- Commencement of development with a view to sale (transfer from investment property to inventories)
- End of owner-occupation (transfer from owner-occupied property to investment property);
- Commencement of an operating lease to another party (transfer from inventories to investment property)
- End of construction or development (transfer from property in the course of construction/development to investment property.
- When an entity decides to sell an investment property without development, the property is not reclassified as investment property but is dealt with as investment property until it is disposed of.

Accounting for Transfers

<u>From</u>	<u>Transferred Category</u>	<u>Treatment</u>
Investment property carried at fair value	Owner-occupied property or inventories	Fair value at the change of use is the 'cost' of the property under its new classification
Owner-occupied property	Investment property carried at fair value	Difference in carrying amount and fair value as revaluation under PAS 16
Inventories	Investment property at fair value	Difference in carrying amount and fair value is recognized in profit or loss.
Investment property under construction or development	Completed investment property that will be carried at fair value	Difference between the fair value at the date of transfer and the previous carrying amount should be recognized in net profit or loss
Investment property under the cost model	Owner-occupied property or inventories	No change the carrying amount of the property transferred

Disposals

- An investment property should be derecognized on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.
- The gain or loss on disposal is the difference between the net disposal proceeds and the carrying amount of the asset and recognized in profit or loss.
- Compensation from third parties is recognized when it becomes receivable.

Disclosures under the Fair Value Model and Cost Model

- a. Whether the fair value or the cost model is used
- b. If the fair value model is used, whether property interests held under operating leases are classified and accounted for as investment property;
- c. If classification is difficult, the criteria to distinguish investment property from owner-occupied property and from property held for sale.
- d. The methods and significant assumptions applied in determining the fair value of investment property.
- e. The extent to which the fair value of investment property is based on a valuation by a qualified independent valuer; if there has been no such valuation, that fact must be disclosed.
- f. The amounts recognized in profit or loss for:
 - Rental income from investment property;
 - Direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period; and
 - Direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period.
- g. Restrictions on the realizability of investment property or the remittance of income and proceeds of disposal.
- h. Contractual obligations to purchase, construct, or develop investment property or for repairs, maintenance or enhancements.

- - END - -

FINANCIAL ACCOUNTING AND REPORTING

ACCOUNTING FOR DIVIDENDS AND STOCK RGHTS

Dividends – Distribution of earnings paid to shareholders based on the number of shares owned. The most common type of dividend is a cash dividend. Dividends may be issued in other forms such as stock and property.

Dividends are typically recognized as income by the investor/shareholder, unless it is a **liquidating dividend, the equity method is being applied or the dividends are in the form of shares.**

Cash dividends are recognized as income **regardless** whether the dividends comes from the cumulative net income after the date of the investment (post acquisition retained earnings) or net income prior to the acquisition of the investment (pre-acquisition retained earnings). Previously, it was addressed in a PFRS that dividends from pre-acquisition retained earnings are liquidating dividends. This treatment has now been superseded by revisions to PAS 27.

Basic rules on dividends

- a. Cash dividends – Income recognized at the date of declaration, which is the date the board of directors announces its intention to pay dividends.
- b. Property dividends – Income at fair value.
- c. Stock or share dividends – Recorded as a memorandum entry, however two important cases to take note of:
 - 1. A different class of shares received other than the original investment known as “**special stock dividends**” shall be recognized as a new investment, therefore the TOTAL cost of the investment shall be allocated using the “**relative fair value method**”. A common accounting problem considered under these cases will be if only a single fair value is given. In this instance, the available fair value shall simply be deducted from the total cost and the difference shall be the value allocated to the remaining investment.

Total cost of 20,000 ordinary share investment 5,000,000

Assume that, 10,000 preference shares are received with a fair value of 60 per share and the fair value of the 20,000 ordinary shares that originally cost 250 each is 270.

	Total Fair Value	Fraction / Ratio
Ordinary (20,000 x 270)	5,400,000	5.4/6 (90%)
Preference (10,000 x 60)	600,000	.6/6 (10%)
Total	6,000,000	

Although not income and entry shall be recorded at

Investment in preference shares (10% x 5M) 500,000
Investment in ordinary shares 500,000

If the fair value of the ordinary shares is not provided, the preference share investment shall be recorded at 600,000

- 2. Stock dividends **will also reduce the cost per share** as a result of the same or original cost being allocated to a larger number of shares. This will of course be a factor in subsequent sale transactions related to the investment.

If an investment of 50,000 shares is acquired at a total cost of 5,000,000 receives a 20% share dividend distribution or a total of 10,000 additional shares, the before and after cost per share is computed as follows:

Cost per share **before** share dividends (5,000,000 divided by 50,000) 100 / share
Cost per share **after** share dividends (5,000,000 divided by 60,000) 83.33 / share

When Are Shareholders Entitled to Dividends

As mentioned earlier, dividends are recognized as income at the date of declaration. Meaning, dividends receivable shall be debited and a corresponding credit to dividend income. But to determine whether the shareholder should get a dividend, you need to look at two important dates. They are the "record date" or "date of record" and the "ex-dividend date" or "ex-date."

When a company declares a dividend, it sets a record date when the shareholder must be on the company's books as a shareholder to receive the dividend. Companies also use this date to determine who is sent financial reports and other information.

Once the company sets the record date, the ex-dividend date is set based on stock exchange rules. The ex-dividend date is usually set for stocks **two business days before** the record date. If a buyer purchases the stock on its ex-dividend date or after, they will not receive the next dividend payment. Instead, the seller gets the dividend. If the buyer purchases before the ex-dividend date meaning "dividend on", the buyer will get the dividend.

Here is an example:

Declaration Date	Ex-Dividend Date	Record Date	Payable Date
Thursday, 9/1/2016	Tuesday, 10/4/2016	Thursday, 10/6/2016	Tuesday, 10/25/2016

If shares cost the investor 1,000,000 and a dividend receivable of 100,000 is recorded on the declaration date, selling the shares for example 1,500,000 will result in a gain of only 400,000 if sold between 9/1/2016 and 10/3/2016 because it is "dividend on" and 500,000 if sold between 10/4/2016 and 10/24/2016 since it is "ex-dividend".

Accounting for Stock Rights

Stock rights are issued to shareholders in order to maintain their proportionate ownership interest in the corporation when new shares are issued at a discounted price compared to a public offering and for a limited period only usually several weeks. The ratio is one stock right for every share owned by a shareholder. However, the number of stock rights to buy one additional share shall not be the same. There are opposing views in accounting for stock rights and the illustration below will show both.

Let us assume that a shareholder has 50,000 shares with a total cost of 5,000,000 or 100 per share and is issued 50,000 stock rights to acquire 10,000 shares at 140 each. The fair value of the shares is 160 each and the stock right is 10 each.

Accounted for Separately		Not Accounted for Separately	
Total Fair Value of SR (50,000 x 10)		500,000	
Journal Entry:		Only a "memo entry" is recorded for the receipt of the stock rights. And the exercise and acquisition of the shares shall only be the exercise price.	
Investment in Stock Rights	500,000	Exercise price (10,000 x 140)	
Investment in Stocks	500,000	1,400,000	
Exercise price (10,000 x 140)	1,400,000	Journal Entry:	
Cost of stock rights exercise	500,000	Investment in Stocks	
Total cost of new investment	1,900,000	Cash	
Journal Entry:		1,400,000	
Investment in Stocks	1,900,000	Investment in Stocks	
Cash	1,400,000	Cash	
Investment in Stocks	500,000	500,000	

- **Accounting for stock rights separately** has been the traditional approach followed for several decades already although unlike before where the total cost of the investment is multiplied by the fraction that can be developed by adding the fair value of the share and the stock right (example: $5,000,000 \times 10/170$) depending whether the shares are quoted “right-on” or “ex-right”. The fair value is simply used as the value to be allocated as the separate investment of the stock rights based on the theoretical basis under PFRS 9 that “all investments and contracts on those instruments must be measured at fair value”
- If stock rights are **not accounted for separately**, this is in line with another instrument described in PFRS 9 known as embedded derivatives where the stock rights can be rightfully classified. Embedded derivatives shall not be separated from the host contract if the host contract is a financial asset. Of course the investment in stocks is a financial asset.
- That’s why it will be wise to proceed with caution and identify the requirements specifically mentioned in the problem on how to treat stock rights since both treatments are acceptable under PFRS 9.

Theoretical Value of Stock Rights

This is a formula that shall be applied to derive the fair value of the stock rights in case it is not determinable in a specific situation. There are two applications of the formula depending whether the shares are quoted “right-on” or “ex-right”.

RIGHT-ON

$$\frac{\text{Market value of share less Exercise Price}}{\text{Number of rights to purchase one share} + 1}$$

EX-RIGHT

$$\frac{\text{Market value of share less Exercise Price}}{\text{Number of rights to purchase one share}}$$

The formulas are identical except for one little detail, the denominator for the “right-on” formula shall have a plus 1 factor to represent the market value of the stock right that is included in the market value of the share since it is quoted “right-on”.

Let’s assume that 50,000 shares are acquired for 5,000,000 and 50,000 rights are issued to purchase 12,500 shares or 4 rights to purchase one share at an exercise price of 100. The shares are quoted at 125 and stock rights shall be accounted for separately.

The market value of the stock rights if “right-on” is $5 (125 - 100) / (4 + 1)$ and 6.25 is “ex-right” $(125 - 100) / 4$. The cost of the new investment shall be

RIGHT-ON

Exercise price (12,500 x 100)	1,250,000
Cost of stock rights (5 x 50,000)	<u>250,000</u>
Total cost of new investment	<u>1,500,000</u>

EX-RIGHT

Exercise price (12,500 x 100)	1,250,000
Cost of stock rights (6.25 x 50,000)	<u>312,500</u>
Total cost of new investment	<u>1,562,500</u>

Shares in lieu of cash dividends and cash in lieu of stock dividends

Let us assume that 50,000 shares are acquired at a cost of 3,000,000.

Situation 1: A dividend per share of 20 is declared but 5,000 shares with a fair value of 150 each is issued

Situation 2: A 20% stock dividend is declared but instead cash dividends of 600,000 are received

Under situation 1, shares in lieu of cash, this shall be recognized **as a property dividend** and be recorded as income at 750,000 (5,000 x 150), the fair value of the shares received. If the fair value of the shares is not available, the amount of income shall be 1,000,000 (50,000 x 20)

Under situation number 2, cash in lieu of stock dividends, the “**as if sold approach**” shall be followed. Step 1 will be to compute for the new cost per share if the share dividends were received which is 50 per share ($3,000,000 / 50,000 + 10,000 (20\% \times 50,000)$). Then the number of share dividends that would have been received shall be multiplied by 50 and compared to amount of cash dividends received and a gain or loss on sale shall be recognized. **Therefore the gain is 100,000 (600,000 less (50 x 10,000))**

-- END --

FINANCIAL ACCOUNTING AND REPORTING

RECLASSIFICATION OF FINANCIAL ASSETS

Conditions for Reclassification of Financial Assets

Under PFRS 9, reclassification of financial assets **is required** if, and only if, the objective of the entity’s **business model for manages those financial assets changes**.

Timing of Reclassification of Financial Assets

If the entity determines that its business model has changed in a way that is significant to its operations, then it reclassifies all affected assets **prospectively from the first day of the next reporting period** (the reclassification date). Prior periods are not restated.

<u>Original Category</u>	<u>New Category</u>	<u>Accounting Impact</u>
Amortized cost	FVPL	Fair value is measured at reclassification date. Difference from carrying amount should be recognized in profit or loss.
FVPL	Amortized Cost	Fair value at the reclassification date becomes its new gross carrying amount
Amortized cost	FVOCI	Fair value is measured at reclassification date. Difference from amortized cost should be recognized in OCI. Effective interest rate is not adjusted as a result of the reclassification.
FVOCI	Amortized cost	Fair value at the reclassification date becomes its new amortized cost carrying amount. Cumulative gain or loss in OCI is adjusted against the fair value of the financial asset at reclassification date.
FVPL	FVOCI	Fair value at reclassification date becomes its new carrying amount.
FVOCI	FVPL	Fair value at reclassification date becomes carrying amount. Cumulative gain or loss on OCI is reclassified to profit or loss at reclassification date

Let us assume the following amounts for cost, fair value and amortization from 2016 to 2018. All amounts have no basis for computation and have been simplified for expediency. The original cost of the financial asset is **4,600,000 with a face value of 5,000,000** and the following information has been gathered at the end of the year on December 31, 2016, 2017 and 2018.

	<u>12/31/16</u>	<u>12/31/17</u>	<u>12/31/18</u>
Fair Value	5,200,000	5,400,000	5,500,000
Amortization on original cost	50,0000	70,000	90,000

Interest Income	70,000	
FA at FVOCI		70,000
FA at FVOCI	170,000	
Unrealized gain - OCI		170,000
$(5,500,000 - (5,400,000 - 70,000)) = 170,000$		

12/31/2018		
FA at AC	90,000	
Interest Income		90,000

FVPL TO FVOCI		
12/31/2016		
FA at FVPL	600,000	
Unrealized gain		600,000
12/31/2017		
FA at FVPL	200,000	
Unrealized gain		200,000
1/1/2018		
FA at FVOCI	5,400,000	
FA at FVPL		5,400,000
12/31/2018		
Interest Income	70,000	
FA at AC		70,000
FA at FVOCI	170,000	
Unrealized gain - OCI		170,000
$(5,500,000 - (5,400,000 - 70,000)) = 170,000$		

FVOCI TO FVPL		
12/31/2016		
FA at FVOCI	50,000	
Interest Income		50,000
FA at FVOCI	550,000	
Unrealized gain – OCI		550,000
12/31/2017		
FA at FVOCI	70,000	
Interest Income		70,000
FA at FVOCI	130,000	
Unrealized gain – OCI		130,000
1/1/2018		
FA at FVPL	5,400,000	
FA at FVPL		5,400,000
Unrealized gain - OCI	680,000	
Gain on FVPL		680,000
12/31/2018		
FA at FVPL	100,000	
Unrealized gain (P/L)		100,000

-- END --

FINANCIAL ACCOUNTING AND REPORTING

INITIAL MEASUREMENT OF PPE

I. Definitions

Cost Amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other PFRS.

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

Property, plant and equipment are **tangible items** that:

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

Recognition

Items of property, plant, and equipment should be recognized as assets when it is probable that:

- The future economic benefits associated with the asset will flow to the enterprise; and
- The cost of the asset can be measured reliably.

Measurement at Recognition - An item of property, plant and equipment that qualifies for recognition, as an asset shall be measured at its cost.

Elements of Cost

The cost of an item of property, plant and equipment comprises:

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

Examples of directly attributable costs are:

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

Examples of costs **that are not** costs of an item of property, plant and equipment and should be expensed:

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

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

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

Measurement of Cost

Measurements with an **order of priority** to be followed:

	Issuance of Shares	Issuance of Bonds	Exchange Transaction with difference in Cash Flows
1 st	FV of Asset	FV of Bonds	FV of Asset Given
2 nd	FV of Shares	FV of Asset	FV of Asset Received
3 rd	Par value of Shares	Face value of BP	BV of Asset Given

Assets acquired by an exchange transaction shall be adjusted for the amount of cash paid or received.

Measurements that use the **cash price** or its equivalent

Acquired though short term credit -	Cost should be net of the discount regardless whether taken or not.
Acquired through long term financing -	Present value of the deferred payment or the installments

Measurements at fair value of the asset received only

Asset donated by a shareholder -	Recorded at the fair value of the asset. An equity account “Donated Capital” shall be credited which is part of share premium. However, cost incurred to transfer the title paid by the recipient shall not be capitalized , instead debited from Donated Capital.
Asset from a government grant -	Also recorded at fair value. Income shall be credited if there are no conditions attached and cost incurred to transfer the title shall be recognized as an expense.

Other measurement considerations

Self Constructed asset -	Includes the cost of materials, direct labor and overhead specifically attributable to the construction. Savings from the construction, meaning lower total cost compared if the assets was purchased are not included in the cost and shall not be recognized as income.
Exchange transactions that lacks commercial substance -	This term “lacks commercial substance” applies if an both assets from the exchange represents a configuration (RISK, TIMING AND AMOUNT) of cash flows that does not differ from each other. Therefore the transaction shall be accounted for in a manner that no exchange occurred and shall be measured at book value of the asset given with NO “gain or loss” to be recognized.

GOVERNMENT GRANTS AND GOVERNMENT ASSISTANCE

Definitions

Government assistance Action by government designed to provide an economic benefit **specific to an entity or range of entities** qualifying under certain criteria. Government assistance for the purpose of this Standard does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government grants Assistance by government in the form of transfers of resources to an entity in **return for past or future** compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Grants related to assets Government grants whose primary condition is that an entity qualifying for them should **purchase, construct or otherwise acquire** long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income Government grants **OTHER** than those related to assets.

Government Grants, including non-monetary grants at fair value, shall not be recognized until there is reasonable assurance that:

- (a) The entity will comply with the conditions attaching to them; and
- (b) The grants will be received.

There are **four types** of significant government grants that will require the following treatment:

1. Grants for the purpose of **specific expenses** – This should be deferred and recognized as income in the same period as the relevant expense.
2. Grants related to **depreciable assets** are usually recognized as income over the periods and in the proportions in which depreciation on those assets is charged. Either by deducting the grant from the cost of the asset or as deferred income.
3. Grants related to **non-depreciable** assets may also require the fulfillment of certain obligations and would then be recognized as income over the periods which bear the cost of meeting the obligations. As an example, a grant of land may be conditional upon the erection of a building on the site and it may be appropriate to recognize it as income over the life of the building.
4. A government grant that becomes receivable as compensation for **expenses or losses already incurred** or for the purpose of giving immediate financial support to the entity with no future related costs shall be recognized as income of the period in which it becomes receivable.

Presentation of Grants Related to Assets

- a. **Government grants related to assets, including non-monetary grants at fair value, shall be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.**
- b. Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to assets are regarded as acceptable alternatives.
- c. One method sets up the grant as deferred income which is recognized as income on a systematic and rational basis over the useful life of the asset.

- d. The other method deducts the grant in arriving at the carrying amount of the asset. The grant is recognized as income over the life of a depreciable asset by way of a reduced depreciation charge.
- e. The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an entity. For this reason and in order to show the gross investment in assets, such movements are often disclosed as separate items in the cash flow statement regardless of whether or not the grant is deducted from the related asset for the purpose of balance sheet presentation.

Presentation of Grants Related to Income

- a. Grants related to income are sometimes presented as a credit in the income statement, either separately or under a general heading such as "Other income"; alternatively, they are deducted in reporting the related expense.
- b. Supporters of the first method claim that it is inappropriate to net income and expense items and that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant. For the second method it is argued that the expenses might well not have been incurred by the entity if the grant had not been available and presentation of the expense without offsetting the grant may therefore be misleading.
- c. Both methods are regarded as acceptable for the presentation of grants related to income. Disclosure of the grant may be necessary for a proper understanding of the financial statements. Disclosure of the effect of the grants on any item of income or expense, which is required to be separately disclosed, is usually appropriate.

Repayment of Government Grant

- a. If a grant becomes repayable, it should be treated as a **change in estimate**.
- b. If the grant is recorded as a deferred income, the repayment should be applied first against any related unamortized deferred income (the balance of the deferred income), and the difference shall be recognized as expense.
- c. Where the original grant related to an asset, the repayment should be treated as increasing the carrying amount of the asset or reducing the deferred income balance.
- d. The cumulative depreciation which would have been charged had the grant not been received should be charged as depreciation expense.

- - END - -

FINANCIAL ACCOUNTING AND REPORTING

COST OF LAND

- a) Purchase price of the land and transaction cost. Transaction cost includes non recoverable taxes like documentary stamps, land registration and transfer taxes. This will also include legal fees, title search and title guarantee insurance and survey fee. The purchase price shall be treated in one of the two following manners in case there is an old building on the land that was purchased **BASED ON A NEW PIC.**
- If the **OLD BUILDING IS USABLE** regardless of the intention to demolish the building. The purchase price shall be allocated based on the relative fair value of the land and old building. Once again, inability to determine the fair value of both assets, the land and the building is a simple hurdle in allocating the purchase price. It simply means that the determinable fair value shall be deducted from the total purchase price and allocated to the other asset. For example if Land and a USABLE OLD BUILDING is acquired for 5,000,000 and the FV of the land is 5,400,000 and the building is 600,000.
 - 4,500,000 shall be capitalized as land (5.4 / 6) and 500,000 shall be capitalized s building regardless if there is an intention to use the old building or demolish it to construct a new building as long as it is **USABLE**.
 - If we can only determine the fair value of the building, 600,000 will be the cost of the building and 4,400,000 (5,000,000 – 600,000) shall be the cost of the land.
 - If the **OLD BUILDING IS UNUSABLE** it is highly probable that the building shall be demolished right away and any intention to use it is diminished. Therefore, the entire purchase price shall be recorded as **LAND ONLY**.

WHAT HAPPENS TO THE COST OF THE OLD USABLE BUILDING WHEN DEMOLISHED?

- The answer will depend on the classification of the land and the new building to be constructed.

	<u>PPE</u>	<u>Investment Property</u>	<u>Inventory</u>
COST of OLD BUILDING	LOSS/EXPENSE	LOSS/EXPENSE	CAPITALIZED
DEMOLITION COST	CAPITALIZED AS BUILDING	CAPITALIZED AS INVESTMENT PROPERTY	CAPITALIZED AS INVENTORY
SALVAGED VALUE	DEDUCTED	DEDUCTED	DEDUCTED

Reasoning behind requirements:

- **Cost of OLD BUILDING** – PPE and Investment property shall be initially measured at cost which includes cost that are “directly attributable” to bring the asset to the condition intended by management (PAS 16 and PAS 40), hence the cost of the old building is not directly attributable cost. Meanwhile, the cost of inventories shall include “indirect cost such as indirect labor and overhead” (PAS 2), therefore this loose classification **somewhat** justifies the capitalization of the cost of the old building. Unlike for PPE and IP where the requirement is very strict and specific.
- **DEMOLITION COST THAT IS CAPITALIZED** - For ages, the demolition cost has been capitalized as land since this is cost to prepare the land for its intended use, but now the demolition cost has been likened to site preparation cost for items like machinery and equipment. This is the basis of the conclusion of the PIC in capitalizing the demolision cost to the “NEW BUILDING (ACCOUNT)”.

- However, if the classification is INVESTMENT PROPERTY or INVENTORY, only one account shall be used and there is no allocation between land and building. Therefore the demolition cost is capitalized to that single account only.
 - **REMEMBER THAT THIS WILL ONLY APPLY TO NEW BUILDING THAT IS DEMOLISHED. AN OLD EXISTING BUILDING AND THE DEMOLITION COST SHALL ALWAYS BE EXPENSED.**
- b) Unpaid mortgages and taxes in arrears assumed by the buyer.
- c) Special assessment
- d) Cost to relocate present occupants from existing operating lease contracts and informal settlers.
- e) Option money or the reservation fee for land that is finally acquired. This should not be confused with earnest money that is a down payment and part of the purchase price.
- f) Cost of permanent improvements to the land that are determined to be nondrepreciable. This once again should be clearly distinguished concrete and metal structures that are naturally temporary an subject to wear and tear with the potential for replacement. Such items shall still be capitalized as “land improvement”

BORROWING COSTS

<u>Borrowing Cost</u>	Interest and other costs incurred by an enterprise in connection with the borrowing of funds. Borrowing cost may include: a) Interest expense calculated using the effective interest method. b) Finance charges in respect of finance leases c) Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.
<u>Qualifying Asset</u>	An asset that takes a substantial period of time to get ready for its intended use. Examples include: a) Inventories b) Manufacturing plants c) Power generation facilities d) Intangible assets e) Investment properties. Financial assets, and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

Accounting Treatment The revised PAS 23 has specifically mentioned that interest on loans applied to qualifying assets **should be capitalized**. This eliminates the benchmark and alternative treatment.

Borrowing Costs Eligible for Capitalization

- **Specific Borrowings** - To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset shall be determined as the **actual borrowing costs** incurred on that borrowing during the period **less any investment income** on the temporary investment of those borrowings.
- **General Borrowings** - To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization shall be determined by applying a **capitalization rate** to the **expenditures on that asset**. The capitalization rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalized during a period **shall not exceed** the amount of borrowing costs incurred during that period.

Commencement of Capitalization

The capitalization of borrowing costs, as part of the cost of a qualifying asset shall commence when:

- (a) Expenditures for the asset are being incurred
- (b) Borrowing costs are being incurred
- (c) Activities that are necessary to prepare the asset for its intended use or sale are in progress.

Suspension of Capitalization

Capitalization of borrowing costs shall be suspended during extended periods in which active development is interrupted.

Cessation of Capitalization

Capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. When the construction of a qualifying asset is completed in parts and each part is capable of being used while construction continues on other parts, capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare that part for its intended use or sale are completed.

Disclosure

The financial statements shall disclose:

- (a) The accounting policy adopted for borrowing costs;
- (b) The amount of borrowing costs capitalized during the period; and
- (c) The capitalization rate used to determine the amount of borrowing costs eligible for capitalization.

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FINANCIAL ACCOUNTING AND REPORTING

DEPRECIATION AND DEPLETION

<u>Carrying amount</u>	The amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses.
<u>Cost</u>	The amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other IFRS.
<u>Depreciable amount</u>	The cost of an asset, or other amount substituted for cost, less its residual value.
<u>Depreciation</u>	The systematic allocation of the depreciable amount of an asset over its useful life.
<u>Residual value</u>	The estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.
<u>Useful life</u>	(a) The period over which an asset is expected to be available for use by an entity; or (b) The number of production or similar units expected to be obtained from the asset by an entity.

Depreciation

- Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.
- The depreciation charge for each period shall be recognized in profit or loss unless it is included in the carrying amount of another asset for example depreciation on factory equipment which shall be included as overhead and cost of inventories.

Depreciable Amount and Depreciation Period

- The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.
- The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate
- Depreciation is recognized even if the fair value of the asset exceeds its carrying amount; as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.
- The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.
- Depreciation of an asset begins when it is available for use. Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale and the date that the asset is derecognized. Therefore, depreciation does **not cease when the asset becomes idle or is retired** from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.
- Factors are considered in determining the useful life of an asset:
 - (a) Expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.
 - (b) Expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.
 - (c) Technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.
 - (d) Legal or similar limits on the use of the asset, such as the expiry dates of related leases.

Depreciation Method

- The depreciation method used shall reflect the pattern in which the asset’s future economic benefits are expected to be consumed by the entity.
- The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate
- A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the **straightline method**, the **diminishing balance method** and the **units of production method**.

Example: Let us assume an asset acquired for 2,200,000 with a residual value of 400,000 at the end of its 5 year useful life and is expected to produce 100,000 units of output at 15,000 (year 1), 20,000 (Y2), 30,000 (Y3), 25,000 (Y4) and 10,000 (Y5). Depreciation each year shall be computed as follows:

	Straight-line	SYD	Double-Declining	Production
	DA divided by UL Or DA x SL Rate	SYD = 1+2+3+4+5 DA x (RL/SYD)	Cost x 2 over Life BV x 2 over Life BV less RV (final year)	Rate = DA / Total output Current output x rate 1.8M / 100,000 = 18
Y1	1.8M / 5 = 360,000	1.8M x 5/15 = 600,000	2.2M x 40% = 880,000	15,000 x 18 = 270,000
Y2	1.8M / 5 = 360,000	1.8M x 4/15 = 480,000	1.32M x 40% = 528,000	20,000 x 18 = 360,000
Y3	1.8M / 5 = 360,000	1.8M x 3/15 = 360,000	792K x 40% = 316,800	30,000 x 18 = 540,000
Y4	1.8M / 5 = 360,000	1.8M x 2/15 = 240,000	475.2K – .4M = 75,200	25,000 x 18 = 450,000
Y5	1.8M / 5 = 360,000	1.8M x 1/15 = 120,000	No Depreciation	10,000 x 18 = 180,000

KEY OBSERVATIONS

- SL provides uniform depreciation, SYD and Double-declining provides accelerated and declining depreciation while production provides variable amount of depreciation.
- SL, SYD and Production method uses depreciable amount from beginning to end. Double declining ignores the residual value in the initial year and depreciates the book value after that, but still adheres to the depreciation of the depreciable amount only that’s why the depreciation in year 4 is only the difference between the book value and residual value. Year four is also the final year of depreciation because at this point the asset is fully depreciated.
- Depreciation for SYD and Double-Declining for a portion of a year is computed by multiplying the amount of depreciation by the number of month’s outstanding divided by 12. For example depreciation in the second year of the useful life for 9 months shall be 360,000 (480,000 x 9/12) for SYD and 396,000 (528,000 x 9/12) for Double-Declining.

WASTING ASSETS are natural resources property in the form of land containing mineral deposits, precious stones and metals or trees to be harvested as logs and lumber with a limited life and will be subject to depletion using the production method.

The total cost of the wasting asset shall be:

- (a) Acquisition cost - Purchase price of the property.
- (b) Exploration cost- Cost incurred to locate the minerals and other resources beneath the surface of the property.
- (c) Development cost - Cost incurred for the actual production or extraction of the minerals and other resources. Development cost is naturally incurred multiple number of times during the period of production and will usually cause the recomputation of the rate. Development cost related to other tangible assets should not be capitalized as part of the wasting asset rather as other items of PPE and depreciated separately, like equipment, machinery and processing facilities.
- (d) Restoration cost - Future cost to be paid to restore the property back to its original condition but recorded as a provision (liability that is estimated) at its present value.

Example: Land containing iron ore is acquired at 50,000,000 with an expected residual value of 4,000,000 at the end of its useful life of 5 years. Geological estimates after exploration activities expect that 2,000,000 tons of iron ore can be produced. The following information has been gathered for two years of mining activities.

	<u>Year 1</u>	<u>Year 2</u>
Exploration cost	5,000,000	-
Development cost related to extraction	7,000,000	3,000,000
Expected restoration cost	3,000,000	
PV of restoration cost	1,800,000	
Tons produced	300,000	400,000
Tons remaining	1,700,000	1,000,000
Tons sold	100,000	500,000
Development cost related to equipment	5,000,000	
Residual value of equipment	500,000	

KEY VARIABLES

- The total cost of the wasting asset is 63,800,000 and the depletable base is 59,800,000. The equipment shall be recorded as a separate asset and depreciated using specific rules that will be discussed later. LET US ASSUME THAT THE EQUIPMENT HAS A 10 YEAR LIFE.
- The rate for year 1 is 29.9 per ton (59,800,000 divided by 2,000,000)
- The rate for year 2 is much more complicated to compute. First, the depletion in year 1 shall be deducted from 59,800,000. Then the additional development cost of 3,000,000 shall be added to the balance. The total amount will then be divided by the new expected output from the beginning of the year which is 1,400,000 (400,000 + 1,000,000). There is a change in accounting estimate in the expected output since the original estimate was 2,000,000 and 300,000 in year 1 and 400,000 in year 2 would indicate that 1,300,000 should still be remaining after year 2.
- The year 2 rate is:

Year 1 Depletion base	59,800,000
Less: Year 1 depletion (29.90 x 300,000)	8,970,000
Depletion base balance	50,830,000
Year 2 Development cost	3,000,000
Total	53,830,000
Divided by: Estimated output (revised)	1,400,000
Year 2 rate	<u>38.45 per ton</u>

	<u>Year 1</u>	<u>Year 2</u>
Total depletion is rate x actual production:		
(300,000 x 29.90) and (400,000 x 38.45)	8,970,000	15,380,000
Depletion in cost of sales is rate x units sold:		
Year 1 (100,000 x 29.90)	2,990,000	
Year 2 (200,000 x 29.90) + (300,000 x 38.45)		17,515,000

WASTING ASSET DOCTRINE: Wasting asset corporations are allowed to declare dividends in excess of the retained earnings balance but the ceiling or upper limit is the amount of realized depletion or the depletion already recognized in cost of sales amounting to 20,505,000 (2,990,000 + 17,515,000). If let's say that the entity has retained earning amounting to P10,000,000. It may declare dividends up to 30,505,000 otherwise known as maximum dividends.

DEPRECIATION OF ASSETS USED IN THE WASTING ASSET

- If the depreciable asset has a future use, the asset is depreciated using its own useful life under the same depreciation methods for similar assets, for example our asset above shall be depreciated at 450,000 annually (5M – 500,000) divided by 10 years.
- If the depreciable asset has no future use, but the useful life is shorter than the life of the asset, the asset **will again** be depreciated using its own useful life under the same depreciation methods for similar assets. Depreciation will be 1,125,000 annually (5M – 500,000) divided by 4 years if we assume that it is shorter than the 5 year useful life of the wasting asset.
- If the life of the wasting asset, the production method shall be used. Therefore the rate of 2.25 per ton shall be used (4,500,000 / 2,000,000) and depreciation for the first year shall be 675,000 (2.25 x 300,000).
- A problem shall arise if there is a **shutdown** because depreciation on an asset shall not cease because it is idle. Let's assume that there is a shutdown in the second year but production resumes in Year 3 and the estimated output is unchanged at 1,700,000 tons and 200,000 tons is extracted in Year 3. We will also be using the 10 year life originally stated above.

Year 1 depreciation (2.25 x 300,000)	675,000
Year 2 depreciation (4,500,000 – 675,000) / 9 years	425,000
Year 3 rate = (4,500,000 – 675,000 – 425,000) / 1,700,000	2 per ton
Year 3 depreciation (2 x 200,000)	<u>400,000</u>

FINANCIAL ACCOUNTING AND REPORTING

SUBSEQUENT MEASUREMENT – REVALUATION MODEL

<u>COST MODEL</u>	Cost less accumulated depreciation and accumulated impairment losses
<u>REVALUATION MODEL</u>	Revalued amount less SUBSEQUENT accumulated depreciation and accumulated impairment losses.
<u>REVALUED AMOUNT</u>	Fair value at revaluation date or the depreciated replacement cost.
<u>DEPRECIATED REPLACEMENT COST</u>	If there is no market-based evidence of fair value because of the specialized nature of the item of property, plant and equipment and the item is rarely sold, an entity may need to estimate fair value using an income or a depreciated replacement cost approach. This is the replacement cost at the date of revaluation minus the proportional amount of accumulated depreciation on the original cost. Also known as SOUND VALUE
<u>REVALUATION SURPLUS</u>	Difference of the revalued amount and book value recognized in other comprehensive income rather than “profit or loss”
<u>REALIZATION OF REVALUATION SURPLUS</u>	Revaluation surplus that is transferred to retained earnings when the revalued asset is sold regardless if it is depreciable or nondepreciable. If the asset is depreciable, the amount transferred to RE is the difference between the depreciation on the revalued amount and the depreciation on cost or simply the revaluation surplus balance divided by the remaining life of the asset.
<u>TAXABLE TEMPORARY DIFFERENCE</u>	Occurs when: a) The carrying amount of the asset is higher than the tax base, or b) The carrying amount of the liability is lower than the tax base This will warrant the recognition of a deferred tax liability.

The Revaluation Model

- After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period. The **frequency** of revaluation may be:
 - a) **Annual revaluation** for property, plant and equipment that experience significant and volatile changes in fair value.
 - b) Every **three or five years** for property, plant and equipment with only insignificant changes in fair value.
- When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of the revaluation is treated in one of the following ways:
 - a) **Restated proportionately** with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount. This method is often used when an asset is revalued by means of applying an index to its depreciated replacement cost.
 - b) **Eliminated** against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset. This method is often used for buildings.
- If an item is revalued, the **entire class of assets** to which that asset belongs should be revalued. This is to avoid a mixture of costs and revalued amounts with in a class of property, plant and equipments. The following are examples of separate classes:
 - (a) Land
 - (b) Land and buildings
 - (c) Machinery
 - (d) Ships
 - (e) Aircraft
 - (f) Motor vehicles
 - (g) Furniture and fixtures
 - (h) Office equipment
- If a revaluation results in an increase in value, it should be credited to equity under the heading "revaluation surplus" unless it represents the **reversal of a revaluation decrease** of the same asset previously recognized as an expense, in which case it should be recognized as income.
- The revaluation surplus shall be **transferred to retained earnings** in one of the following ways:

	<u>If Sold</u>	<u>If NOT Sold</u>
The Asset is Depreciable	The balance of revaluation surplus	Revaluation surplus divided by remaining life
The Asset is Non Depreciable	The balance of revaluation surplus	NONE

- If an asset's carrying amount is decreased as a result of a revaluation (meaning impaired), the decrease shall be recognized in profit or loss. However, the **decrease shall be debited directly to equity under the heading of revaluation surplus** to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Example: Land with a cost of 5,000,000 and building with a cost of 20,000,000 with a useful life of 6 years and a residual value of 2,000,000 was acquired 3 years ago and revalued at the start of year 4. The land's replacement cost is 7,000,000 while the building's replacement cost is 30,000,000. The building's remaining useful life is expected to be 5 years, meaning the original estimate 3 years ago would have been 8 rather than 6. At the same time, the building's expected residual value is 4,000,000 rather the original estimate of 2,000,000. The computation for the book value of the building is as follows:

Cost	20,000,000
Less: Accumulated Depreciation (20M – 2M) / 6 x 3	<u>9,000,000</u>
Book value at the date of revaluation	<u>11,000,000</u>

- The ratio of the accumulated depreciation of the asset based on its depreciable amount is 50% (9M divided by 18M)
- The depreciation on the replacement cost of the building will be also 50% of the revised depreciable amount of 26,000,000 (30M – 4M) and the Depreciated replacement cost is as follows:

Replacement cost	30,000,000
Less: Accumulated Depreciation (30M – 4M) x 50%	<u>13,000,000</u>
Depreciated replacement cost at the date of revaluation	<u>17,000,000</u>

- Let us determine the differences on cost, accumulated depreciation and carrying amount in order for the amounts to be recorded under the proportional approach and compare the revised amounts after revaluation.

<u>Proportional Restatement</u>		<u>Elimination Approach</u>	
Cost (30M – 20M)	10,000,000	Decrease in Cost and AD	(9,000,000)
AD (13M – 9M)	(4,000,000)	Increase in Cost / RS (17M – 11M)	6,000,000
Net CA (17M – 11M)	6,000,000		

- The reported values and corresponding accounts by comparison of both methods shall be as follows:

<u>Proportional Restatement</u>		<u>Elimination Approach</u>	
Gross carrying amount	30,000,000	Gross carrying amount	17,000,000
AD	<u>(13,000,000)</u>	AD	<u>0</u>
Net CA	<u>17,000,000</u>	Net CA	<u>17,000,000</u>

- The following final computation until the year-end of year 4 shall be:

	<u>Land</u>	<u>Building</u>	<u>Total</u>
Revalued amount	7,000,000	17,000,000	24,000,000
Less: Book value	<u>5,000,000</u>	<u>11,000,000</u>	<u>16,000,000</u>
RS at gross	2,000,000	6,000,000	8,000,000
Less: Deferred tax at 30%	<u>600,000</u>	<u>1,800,000</u>	<u>2,400,000</u>
RS at net Beginning	1,400,000	4,200,000	5,600,000
Less: RS to RE (4,200,000 / 5)	<u>0</u>	<u>840,000</u>	<u>840,000</u>
RS balance, Ending	<u>1,400,000</u>	<u>3,360,000</u>	<u>4,760,000</u>

- The deferred tax results from the taxable temporary difference which is directly debited from the revaluation surplus in order to recognize a deferred tax liability. While the revaluation surplus on the land is not realized to retained earnings until the land is sold.

IMPAIRMENT OF ASSETS

KEY OBJECTIVES:

- 1. **When** to test assets for impairment. Testing for impairment simply means that the recoverable amount of the asset **shall be estimated and compared** to the carrying amount.
- 2. What is the basis of the **recoverable amount**.
- 3. **When to test** cash generating units for impairment rather than single or individual assets and how to **allocate the impairment loss** as well as the **limitations** to the allocation.
- 4. **When to reverse** impairment losses, the **limitations** of the gain to be recognized in profit or loss as well as **how to allocate** the gain if the reversal is for a cash generating unit.

DEFINITIONS

<u>Carrying amount</u>	Amount at which an asset is recognized after deducting any accumulated depreciation (amortization) and accumulated impairment losses thereon
<u>Cash-generating unit</u>	Smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
<u>Costs of disposal</u>	Incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.
<u>Depreciable amount</u>	The cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.
<u>Fair value less costs to sell</u>	Amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.
<u>Recoverable amount</u>	The higher amount between an asset or a cash-generating unit's fair value less costs to sell and its value in use.
<u>Value in use</u>	The present value of the future cash flows expected to be derived from an asset or cash-generating unit.

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

<u>SCENARIO #1</u> "Internal and external indicators" of impairment	<u>SCENARIO #2</u> Annual impairment testing
1. Items of property plant and equipment 2. Intangible assets with definite useful lives 3. Cash generated units that are tested for impairment due to the unavailability of estimating the recoverable amount of an asset that is impaired included in the CGU.	1. Intangible assets with indefinite lives. 2. Intangible assets not available for use. 3. Cash generating units with allocated goodwill.

Indicators of Impairment

<u>External sources</u>	<u>Internal sources</u>
• Market value declines • Negative changes in technology, markets, economy, or laws • Increases in market interest rates • Company stock price is below book value	• Obsolescence or physical damage • Asset is part of a restructuring or held for disposal • Worse economic performance than expected

Determining Recoverable Amount

- a. **If fair value less costs to sell or value in use is more than carrying amount, it is not necessary to calculate the other amount. The asset is not impaired.**
- b. If fair value less costs to sell cannot be determined, then recoverable amount is value in use.
- c. For assets to be disposed of, recoverable amount is fair value less costs to sell.

Fair Value Less Costs to Sell

- a. If there is a binding sale agreement, use the price under that agreement less costs of disposal.
- b. If there is an active market for that type of asset, use market price less costs of disposal. Market price means current bid price if available, otherwise the price in the most recent transaction.
- c. If there is no active market, use the best estimate of the asset's selling price less costs of disposal.
- d. Costs of disposal are the direct costs only.

Value in Use

The calculation of value in use should reflect the following elements:

- a. An estimate of the future cash flows the entity expects to derive from the asset in an arm's length transaction
- b. Expectations about possible variations in the amount or timing of those future cash flows
- c. The time value of money, represented by the current market risk-free rate of interest
- d. The price for bearing the uncertainty inherent in the asset
- e. Other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

Considerations for Cash Flow Projections

- a. Cash flow projections should be based on reasonable and supportable assumptions, the most recent budgets and forecasts, and extrapolation for periods beyond budgeted projections. presumes that budgets and forecasts should not go beyond five years; for periods after five years, extrapolate from the earlier budgets. Management should assess the reasonableness of its assumptions by examining the causes of differences between past cash flow projections and actual cash flows.
- b. Cash flow projections should relate to the asset in its current condition – future restructurings to which the entity is not committed and expenditures to improve or enhance the asset's performance should not be anticipated.
- c. Estimates of future cash flows should not include cash inflows or outflows from financing activities, or income tax receipts or payments.

Discount Rate

- a. In measuring value in use, the discount rate used should be the pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset.
- b. The discount rate should not reflect risks for which future cash flows have been adjusted and should equal the rate of return that investors would require if they were to choose an investment that would generate cash flows equivalent to those expected from the asset.
- c. For impairment of an individual asset or portfolio of assets, the discount rate is the rate the company would pay in a current market transaction to borrow money to buy that specific asset or portfolio.
- d. If a market-determined asset-specific rate is not available, a surrogate must be used that reflects the time value of money over the asset's life as well as country risk, currency risk, price risk, and cash flow risk. The following would normally be considered:
 - The enterprise's own weighted average cost of capital
 - The enterprise's incremental borrowing rate
 - Other market borrowing rates.

Recognition of an Impairment Loss

- a. An impairment loss should be recognized whenever recoverable amount is below carrying amount.
- b. **The impairment loss is an expense in the income statement unless it relates to a revalued asset where the value changes are recognized directly in equity.**
- c. Adjust depreciation or amortization charges for future periods.

Cash-Generating Units – As mentioned above for scenario #2, it is widely known that goodwill that arises from a business combination shall not be amortized but tested for impairment. However, for obvious reasons goodwill does not have a recoverable amount. Therefore it is the cash generating unit to which goodwill was allocated that will be impairment tested.

The other scenario is our common procedure when an asset indicates factors of impairment then the recoverable amount should be determined for the individual asset. However, if all effort and means have been exhausted to determine the recoverable amount to no avail, then recoverable amount for the asset's cash-generating unit (CGU) shall be determined and a larger scope of impairment testing shall be implemented.

PROCEDURES AFTER TESTING THE CGU FOR IMPAIRMENT REGARDLESS WITH OR WITHOUT GOODWILL

- a) If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit is not impaired.
- b) If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity must recognize an impairment loss.
- c) The impairment loss is allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:
 - First, reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
 - Then, reduce the carrying amounts of the other assets of the unit (group of units) pro rata on the basis OF THEIR BOOK VALUES. However the **cash of the CGU** shall not be impaired

The carrying amount of an asset should not be reduced below the highest of:

- Its fair value less costs to sell (if determinable)
- Its value in use (if determinable) and
- Zero.

****This is the limitation discussed in number 3 of our key objectives from above****

Reversal of an Impairment Loss

- a. INTERNAL AND EXTERNAL INDICATORS OF REVERSAL ARE IDENTIFIED.

<u>External sources</u>	<u>Internal sources</u>
• Significant increase in market value • Changes in technological, market, economic or legal environment • Changes in interest rates • Market interest rates have decreased.	• Changes in way asset is used or expected to be used • Evidence from internal reporting indicates that economic performance of the asset will be better than expected.

- b) **Individual asset** – The difference of the increased recoverable amount is recognized in profit and loss unless asset carried at revalued amount.
- c) **CGUs** – Allocated to assets of CGUs on a pro-rata basis.
- d) **Goodwill** – Impairment of goodwill is never reversed.
- e) **Limitation** – The revised carrying amount after reversal should not exceed the carrying amount of the individual asset and assets within the cash generating unit if impairment loss was not recognized.

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FINANCIAL ACCOUNTING AND REPORTING

INTANGIBLE ASSETS

Definitions

<u>Intangible asset</u>	An identifiable nonmonetary asset without physical substance.
<u>Amortization</u>	The systematic allocation of the depreciable amount of an intangible asset over its useful life.
<u>Cost</u>	The amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other PFRSs.
<u>Fair value</u>	The amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.
<u>Monetary assets</u>	Money held and assets to be received in fixed or determinable amounts of money.
<u>Research</u>	Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
<u>Development</u>	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 commercial production or use.

Two important aspects of the definition of an Intangible Asset are:

- I. **Identifiability** – Identifiable means
 - (a) Is separable, it is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability **OR**
 - (b) Arises from contractual or other legal rights, **regardless** of whether those rights are transferable or separable from the entity or from other rights and obligations.
- II. **Inherent characteristics of assets are:**
 - (a) **Control** - An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits.
 - (b) **Future Economic Benefits** - The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity.
 - (c) **Cost** – An asset shall only be recognized if its cost or value can be measured reliably.

KEY OBSERVATIONS

- Identifiability is the major reason why internally generated goodwill is not recognized as an asset. Aside from lacking control and unmeasurable cost of goodwill.
- Control is the reason why internally generated brands and the skills of employees arising from training or experience is not an asset. However, cost also plays a major role in its non recognition.

Recognition and Initial Measurement

- An enterprise to recognize an intangible asset, whether purchased or self-created **AT COST** if, and only if:
 - It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
 - The cost of the asset can be measured reliably.

Initial Measurement and Subsequent Expenditures

- Intangible assets are initially measured **at cost**.
- Subsequent expenditure on an intangible asset after its purchase or completion should be recognized as an expense when it is incurred
- However in very rare cases that it is probable that this expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and the expenditure can be measured and attributed to the asset reliably.

Internally Generated Intangible Assets

- I. It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in
 - (a) Identifying whether and when there is an identifiable asset that will generate expected future economic benefits;
 - (b) Determining the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations.
- II. To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

(a) A research phase **(b) A development phase**
- III. If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

- I. No intangible asset arising from research (or from the research phase of an internal project) shall be recognized. Expenditure on research (or on the research phase of an internal project) shall be recognized as an expense when it is incurred.
- II. In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognized as an expense when it is incurred.
- III. Examples of research activities are:
 - (a) Activities aimed at obtaining new knowledge
 - (b) The search for, evaluation and final selection of, applications of research findings or other knowledge
 - (c) The search for alternatives for materials, devices, products, processes, systems or services
 - (d) The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

- I. An intangible asset arising from development (or from the development phase of an internal project) shall be recognized if, and only if, an entity can demonstrate all of the following:
 - (a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.
 - (b) Its intention to complete the intangible asset and use or sell it.
 - (c) Its ability to use or sell the intangible asset.
 - (d) How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
 - (e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
 - (f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development.
- II. In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase.
- III. Examples of development activities are:
 - (a) The design, construction and testing of pre-production or pre-use prototypes and models;
 - (b) The design of tools, jigs, moulds and dies involving new technology;
 - (c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
 - (d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.
- IV. Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognized as intangible assets.**
- V. Expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognized as intangible assets.

Measurement Subsequent to Acquisition

Cost model. After initial recognition the benchmark treatment is that intangible assets should be carried at cost less any amortization and impairment losses.

Revaluation model. Intangible assets may be carried at a revalued amount (based on fair value) less any subsequent amortization and impairment losses only if fair value can be determined by reference to an active market. Such active markets are expected to be uncommon for intangible assets.

Classification of Intangible Assets Based on Useful Life

Intangible assets are classified as:

- Indefinite life: No foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.
- Finite life: A limited period of benefit to the entity.

Measurement Subsequent to Acquisition of Intangible Assets with Finite Lives

The cost less residual value of an intangible asset with a finite useful life should be amortized over that life:

- The amortization method should reflect the pattern of benefits.
- If the pattern cannot be determined reliably, amortize by the straight-line method.
- The amortization charge is recognized in profit or loss unless another PFRS requires that it be included in the cost of another asset.
- The amortization period should be reviewed at least annually.
- The asset should also be assessed for impairment in accordance with PAS 36.

Measurement Subsequent to Acquisition of Intangible Assets with Indefinite Lives

- An intangible asset with an indefinite useful life should not be amortized.
- Its useful life should be reviewed each reporting period to determine whether events and circumstances **continue to support an indefinite useful life assessment for** that asset. If they do not, the change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate.
- The asset should also be assessed for impairment in accordance with PAS 36.

Key Principles on Certain Intangible Assets

Patents

- An exclusive right granted by the government to an inventor to control the manufacture, use or sale of an invention
- Cost – Licensing and registration fees only for **APPLIED AND REGISTERED** patents and purchase price and any directly attributable expenditure necessary in preparing the asset for its intended use for **PURCHASED PATENTS**.
- **Principles on amortization:**
 - Amortization is based on the useful life or legal life (20 years), which ever is shorter.
 - If a competing patent is acquired to protect an original patent. The cost of the new patent and the carrying amount of the original patent is amortized over the remaining life of the original patent.
 - If a related patent is acquired to extend the life of an existing patent. The cost of the new patent and the carrying amount of the original patent is amortized over the extended period, unless if the remaining life of the new patent is shorter than the extended period.

Goodwill

- An unidentifiable intangible asset that allows an enterprise to earn above normal income how
- It is only purchased goodwill that is recognized as an asset which is the cost in excess of the fair value of the net assets acquired in a business combination. This the premium paid in acquiring another business or ordinary shares when control is achieved. Countless of times goodwill is referred to as BADWILL because seemingly the purchaser had gotten fleeced in the sale of the net assets of the seller.
- Internally generated goodwill shall not be recognized as an asset.
- Impairment of goodwill is discussed in Hand Out #22
- Methods of *estimating* goodwill
 - Capitalization of “average excess earnings”
 - Capitalization of “average earnings”
 - Purchase or multiples of “average excess earnings”
 - Present value of “average excess earnings”

EXAMPLE : Lets assume that a buyer is planning to buy the business of a competitor. The cumulative net earnings for the past 5 years was P18,000,000. The current value of net assets of the seller was 10,000,000 only. Meaning if the buyer is able to acquire the assets and assume the liabilities at fair value, the purchase price would only be

10,000,000. But let us say that buyer will account for the past performance of the seller and determine it as a contributor to additional income in the future from the purchase of the seller's business. Goodwill is determined by the following assuming a 20 percent rate of return and a 25% capitalization rate?

Average earnings (18M / 5)	3,600,000
Less: Normal earnings (10M x 20%)	<u>2,000,000</u>
Excess earnings or earnings from goodwill	1,600,000
Capitalized at 25% or divided by	<u>25%</u>
Goodwill	<u>6,400,000</u>

- The purchase price will then be 16,400,000 which is the price at fair value plus the goodwill added to the fair value.
- A multiplier of let's say 3 years if the "multiples of excess earnings" is used or a PV factor of 3.17 if the discount rate is 10% and 4 periods shall be used to compute for goodwill if for example the "PV of excess earnings" will be used.

Average earnings (18M / 5)	3,600,000
Capitalized at 25% or divided by	<u>25%</u>
Purchase price	<u>14,400,000</u>

- Remember from above that 2M came from the net assets and 1.6M came from goodwill. That's why if you add the two together the 3.6M comes from the net assets with the goodwill or simply the purchase price.

Trademark

- An exclusive right granted by the government that permits the use of distinctive symbols, labels, and designs associated with the product or the organization.
- Cost – Licensing and registration fees only for developed trademarks Cost of research, survey, design and development cost is expensed.
- The legal life of a trademark is 10 years however it may be renewed for an additional 10 year period for an unlimited number of times. Therefore the legal life of a trademark is indefinite and is not subject to amortization but instead tested for impairment.
-

Computer Software

- IF the **software is an integral part** of the hardware for example the operating system of the PC, the cost of the software shall be included in hardware cost
- Internally developed (whether for use or sale) **charge to expense** until technological feasibility is achieved
- Cost to develop the software shall be capitalized once technological feasibility is reached either from the creation of a "working model or a detailed program design". Probable future benefits, intent and ability to use or sell the software, resources to complete the software, and ability to measure cost are also requirements for capitalization.
- Development activities have concluded and commercial production shall commence once the final or "beta" version of the software has been produced. In accounting specially in US GAAP, the final version is known as the "product master"
- The amortization method for computer software should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If such pattern cannot be determined reliably, the straight-line method is used.

Leasehold Improvements

- Permanent upgrading on leased property under an operating lease.
- This is a tangible asset by nature, however classified as an intangible asset because its an asset where the ownership is not with the lessee who constructed or added the cost to the leased property but ownership is with the lessor since the improvements cannot be detached or taken by the lessee at the expiration of the leaseterm. This will be subject to amortization.
- If the lease contract is nonrenewable, the LHI is simply amortized using the shorter period between the remaining leaseterm and the useful life of the LHI.
- If the lease is renewable, the additional period shall be added to the remaining leaseterm if the extention option has **already been exercise** or the **intention to renew is certain**. This total period will be the one compared to the life of the LHI.
- As you can imagine, this topic is a source of “changes in accounting estimates”.

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✓ TA-257: STATEMENT OF FINANCIAL POSITION & NOTES TO THE FINANCIAL STATEMENTS

Sources: PAS 1/PAS 10/PAS 24/PAS 37/Applicable AICPA/Various test banks

- A 1. The statement of financial position of a reporting entity presents a structured summary of the
- Assets, liabilities and equity at the reporting date
 - Cash receipts and payments of cash during the period
 - Profits and losses not reported in income of the period
 - Revenue and expenses arising during the reporting period
- C 2. Which of the following is an essential characteristic of an asset?
- An asset is tangible
 - An asset is obtained at a cost
 - An asset provides future economic benefits
 - The claims to an asset's benefits are legally enforceable
- B 3. Which of the following statements best describes a liability?
- An excess of equity over current asset
 - A present obligation of the entity arising from past events
 - Resources to meet financial commitments as they fall due
 - The residual interest in the assets of the entity after deducting all of its liabilities
- A 4. Under PAS 1, assets in the statement of financial position are broadly classified into
- Current and non-current
 - Tangible and intangible
 - Depreciable and non-depreciable
 - Monetary and non-monetary
- B 5. Under PAS 1, which of the following does not refer to a *current* asset?
- It is held primarily for the purpose of being traded
 - It is a cash or cash equivalent restricted for more than 12 months from BS date
 - It is expected to be realized within twelve months after the balance sheet (BS) date
 - It is expected to be realized, sold or consumed within the entity's normal operating cycle
- D 6. Under PAS 1, which of the following does not describe a *current* liability?
- It is held primarily for the purpose of being traded
 - It is expected to be settled within the entity's normal operating cycle
 - It is due to be settled within twelve months after the balance sheet date
 - The entity has an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date
- B 7. When an entity BREACHES an undertaking under a long-term loan agreement with the effect that the liability becomes payable on demand, the liability is classified as
- Current, only if the lender demands immediate payment as a consequence of the breach
 - Current, even if the lender has agreed not to demand payment as a consequence of the breach
 - Non-current, only if the lender demands immediate payment as a consequence of the breach
 - Non-current, even if the lender has agreed not to demand payment as a consequence of the breach
- B 8. The REFINANCING (rolling over) of a currently maturing long-term debt completed *on or before the balance sheet date* requires that such debt be classified as a
- Current liability
 - Non-current liability
 - Current liability or non-current liability, at the option of the debtor
 - Non-adjusting event and be disclosed in the notes to the financial statements
- C 9. The REFINANCING (rolling over) of a currently maturing long-term debt of an entity completed *after the balance sheet date but before the FS are authorized for issue* requires that such debt be classified as a
- Current liability, if the refinancing is at the discretion of the entity owing the debt
 - Current liability, the discretion of the entity to refinance the debt notwithstanding
 - Non-current liability, if the refinancing is at the discretion of the entity owing the debt
 - Non-current liability, if the refinancing is not at the discretion of the entity owing the debt
- D 10. Offsetting of assets and liabilities is
- Allowed in all cases
 - Not allowed in all cases
 - Allowed unless not permitted by PFRS
 - Not allowed unless permitted by PFRS

STATEMENT of FINANCIAL POSITION & NOTES to the FS

- A 11. The balance sheet format wherein asset section is shown side-by-side with liabilities & equity section.
- a. Account form
 - b. Report form
 - c. Functional presentation
 - d. Natural presentation
- D 12. Which of the following is not an acceptable presentation of the statement of financial position?
- a. Assets presented in the order of liquidity
 - b. Non-controlling interests presented within equity
 - c. Provisions presented as part of the liability section
 - d. Deferred tax liabilities presented as part of current liabilities
- B 13. Which is not required to be presented as a line item on the face of the statement of financial position?
- a. Biological assets
 - b. Contingent liability
 - c. Investment property
 - d. Investments accounted under equity method
- B 14. An obligation is not a contingent liability but should be recognized as a *provision* when
- a. Obligation is unusual in nature and occurs infrequently
 - b. Amount is measurable and settlement of obligation is probable
 - c. Amount is measurable and settlement of obligation is frequent
 - d. Obligation is unusual in nature and settlement of obligation is probable
- C 15. These provide narrative description or disaggregation of items disclosed on the face of the financial statements and information about items that do not qualify for recognition.
- a. Financial reports
 - b. Value-added statements
 - c. Notes to the financial statements
 - d. Summary of significant accounting policies
- C 16. What is the purpose of information presented in notes to the financial statements?
- a. To present management's responses to auditor comments
 - b. To correct improper presentation in the financial statements
 - c. To provide disclosures required by generally accepted accounting principles
 - d. To provide recognition of amounts not included in the total of the financial statements
- B 17. The application of Philippine Financial Reporting Standards, with *additional disclosures* if necessary, is presumed to result in financial statements that achieve
- a. Aggregation
 - b. Fair presentation
 - c. Comparable information
 - d. Consistency of presentation
- C 18. What is the normal order of presenting the notes to the financial statements?
- A) Statement of measurement basis and accounting policies applied
 - B) Supporting information or computation for line items presented and aggregated in the FS
 - C) Statement of compliance with Philippine Financial Reporting Standards (PFRS)
 - D) Commitments, contingencies, and other required financial and non-financial disclosures.
- a. A,C,B,D
 - b. C,A,D,B
 - c. C,A,B,D
 - d. C,B,A,D
- B 19. Which is not included in the 'accounting policies' section of the notes to the FS?
- a. The measurement basis used in preparing the FS
 - b. The supporting computation for items aggregated on the face of the FS
 - c. The accounting policies used that are relevant to an understanding of the FS
 - d. Whether company is using FIFO or weighted average method for costing inventory
- C 20. An entity is required to present the following non-financial disclosures, *except*
- a. Domicile and legal form of the entity
 - b. Description of the nature of entity's operation
 - c. Names of major shareholders and board members
 - d. Name of parent and ultimate parent of the group of companies
- C 21. Under PAS 24, related parties do not include
- a. Affiliates
 - b. Associates
 - c. Entities that have a common director
 - d. Key management personnel and their close family members
- D 22. Which of the following is not a related party as envisaged by PAS 24?
- a. A director of the entity
 - b. The parent company of the entity
 - c. The son of the chief executive officer of the entity
 - d. A shareholder of the entity that holds 1% stake in the entity

STATEMENT of FINANCIAL POSITION & NOTES to the FS

- C 23. When a related party transaction has occurred, an entity shall disclose in the notes to the financial statements the following information, *except*:
- The nature of the related party relationship
 - The amount of related party transaction (if any)
 - The method of pricing for the related party transaction
 - The amount of outstanding balance and any related provision for bad debts (if any)
- B 24. Relationships between parents and subsidiaries shall be disclosed:
- Only if there have been transactions between these related parties
 - Even if there have been no transactions between these related parties
 - Only if there have been transactions between these related parties and the amount is substantially material
 - Only if there have been transactions between these related parties and the amount is to be settled in normal business terms
- D 25. PAS 24 requires disclosure of compensation of key management personnel. Which of the following would *not* be considered as a compensation for this purpose?
- Short-term benefits
 - Share-based payments
 - Termination benefits
 - ~~Reimbursement of out-of-pocket expenses~~
- C 26. Under PAS 10, *events after the BS date (reporting period)* are favorable and unfavorable events that occur between the:
- BS date and blind date
 - BS date and FS issue date
 - BS date and the date when FS are authorized for issue
 - The date when FS are authorized for issuance and FS issue date
- B 27. The financial statements are authorized for issue when:
- The FS are made available to shareholders
 - The board of directors reviews the FS and authorizes them for issue
 - The shareholders approve the FS at their annual stockholders' meeting
 - The approved FS are filed with a government regulatory body (e.g., SEC)
- A 28. These are post-BS events that provide evidence of conditions that existed at the BS date.
- Adjusting events
 - Non-adjusting events
 - Favorable events
 - Extraordinary events
- B 29. These are post-BS events that are indicative of conditions that arose after the BS date.
- Adjusting events that require certain disclosures in the notes
 - Non-adjusting events that require certain disclosures in the notes
 - Adjusting events that require adjustment of amounts recognized in the FS
 - Non-adjusting events that require adjustment of amounts recognized in the FS
- C 30. Dividends declared by the entity after BS date shall be treated as a(n):
- Adjusting event
 - Contingent event
 - ~~Non-adjusting event~~
 - Extraordinary event

PAS 10 Events after Balance Sheet Date (Reporting Period)

Indicate 'AE' if the post-BS event is classified as an *adjusting event*; otherwise, indicate 'NE' (*non-adjusting event*).

NE	31) Announcement of a plan to discontinue operations
AE	32) Bankruptcy of a customer that occurs after the BS date
NE	33) A major business combination after BS date
NE	34) Abnormally large changes in asset prices or foreign exchange rates
NE	35) Destruction of a major production plant by fire
AE	36) Sale of inventories after BS date that may give evidence about their net realizable value
AE	37) Discovery of fraud or errors that show the FS are incorrect
NE	38) Major common share transactions and potential common share transactions after BS date
NE	39) Expropriation of major assets by the government
AE	40) Determination after BS date of the profit sharing or bonus payment if the enterprise has the present obligation at BS date to make such payment