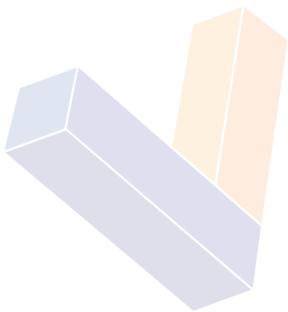
"Pioneers in Professional Education"

CL 02 – Financial Reporting and Governance

Corporate Level

(Handout No 01)



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Conceptual Framework for Financial Reporting

Topic No 01

A conceptual framework is a statement of generally accepted theoretical principles that form the frame of reference for financial reporting.

Advantages and Disadvantages of a Conceptual Framework

Advantages

A. The situation is avoided whereby standards are developed on a patchwork basis, where a **particular accounting problem** is recognized as having **emerged**, and resources were then channeled into standardizing accounting practice in that area, without regard to whether that particular issue was necessarily the most important issue remaining at that time without standardization.

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

C. Some standards may concentrate on profit or loss, whereas some may concentrate on the valuation of net assets (statement of financial position).

Disadvantages

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

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

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

Content of the conceptual framework for financial reporting (2018)

- Chapter 01 - Objective of general-purpose financial reporting
- Chapter 02 - Qualitative characteristics of useful financial information
- Chapter 03 - Financial statements and the reporting entity
- Chapter 04 - The elements of financial statements
- Chapter 05 - Recognition and derecognition
- Chapter 06 - Measurement

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- Chapter 07 - Presentation and disclosure
- Chapter 08 - Concepts of capital and capital maintenance

The introduction to the Conceptual Framework for Financial Reporting (the Conceptual Framework) points out the fundamental reason why financial statements are produced worldwide; that is, to satisfy the requirements of external users.

The preface emphasizes the way financial statements are used to make economic decisions, and thus financial statements should be prepared to this end. The types of economic decisions for which financial statements are likely to be used include the following.

- Decisions to buy, hold or sell equity investments.
- Assessment of management stewardship and accountability.
- Assessment of the entity's ability to pay employees.
- Assessment of the security of amounts lent to the entity.
- Determination of taxation policies.
- Determination of distributable profits and dividends.
- Inclusion in national income statistics.
- Regulations of the activities of entities.

Any additional requirements imposed by national governments for their own purposes should not affect financial statements produced for the benefit of other users.

Purposes of the Conceptual Framework

A) Assist the International Accounting Standards Board (Board) to develop IFRS Standards (Standards) that are based on consistent concepts.

B) Assist preparers to develop consistent accounting policies when no Standard applies to a particular transaction or other event, or when a Standard allows a choice of accounting policy.

C) Assist all parties to understand and interpret the Standards.

Scope of the Conceptual Framework

The Conceptual Framework is concerned with '**general purpose**' financial statements (ie a normal set of annual financial statements), but it can be applied to other types of financial statements.

The Conceptual Framework is not a Standard. Nothing in the Conceptual Framework overrides any Standard or any requirement in a Standard.

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Chapter 01 - The objective of general-purpose financial reporting (paragraph 1.2)

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 relating to providing resources to the entity.

Those decisions involve decisions about:

A) buying, selling or holding equity and debt instruments.
B) providing or settling loans and other forms of credit.
C) exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

The decisions described above depend on the returns that existing and potential investors, lenders and other creditors expect, for example, dividends, principal and interest payments or market price increases. Investors', lenders and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity and on their assessment of management's stewardship of the entity's economic resources. Existing and potential investors, lenders and other creditors need information to help them make those assessments.

To make the assessments described above, existing and potential investors, lenders and other creditors need information about:

(a) the **economic resources** of the entity, **claims** against the entity and **changes in those resources and claims**.

(b) how **efficiently and effectively** the entity's management and governing board.

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

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

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Users and their information needs

User	Need of information
Investors	A) To help make a decision about buying or selling shares, taking up a rights issue and voting. B) Investors must have information about the level of dividend, past, present and future, and any changes in share price. C) Investors will also need to know whether the management has been running the company efficiently. D) As well as the position indicated by the statement of profit or loss and other comprehensive income, statement of financial position and earnings per share (EPS), investors will want to know about the liquidity position of the company, the company's future prospects, and how the company's shares compare with those of its competitors
Employees	Need information about the security of employment and future prospects for jobs in the company, and to help with collective pay bargaining.
Lenders	To help them decide whether to lend to a company. They will also need to check that the value of any security remains adequate, that the interest repayments are secure, that the cash is available for redemption at the appropriate time and that any financial restrictions (such as maximum debt/equity ratios) have not been breached.
Suppliers	To know whether the company will be a good customer and pay its debts.
Customers	To know whether the company will be able to continue producing and supplying goods.
Government	Specifically concerned with compliance with tax and company law, ability to pay tax and the general contribution of the company to the economy.
Public	The public at large would wish to have information for all the reasons mentioned above, but it could be suggested that it would be impossible to provide general purpose accounting information that was specifically designed for the needs of the public.

Information about a reporting entity's economic resources, claims against the entity and changes in resources and claims.

Economic resources and claims	Changes in resources and claims
Provided via **Statement of Financial Position**	Result from that entity's **financial performance** and from **other events or**

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	transactions such as issuing debt or equity instruments.
• Help users to assess the reporting entity's liquidity and solvency. • Help users to assess management's stewardship of the entity's economic resources.	Two types of financial performances can be identified. A) Financial performance reflected by accrual accounting. – **Statement of profit or loss & Other Comprehensive Income** B) Financial performance reflected by past cash flows. – **Statement of Cash Flows**
	Other events and transactions: A) issuing debt or equity instruments

Chapter 02 - Qualitative characteristics of useful financial information

Fundamental qualitative characteristics	Enhancing qualitative characteristics
• Relevance • Faithful Representation	• Comparability • Verifiability • Timeliness • Understandability

Relevance (Para 2.6 onwards)

Relevant financial information is capable of **making a difference in the decisions** made by users. Financial information is capable of making a difference in decisions if it has **predictive value**, **confirmatory value** or both.

Predictive Value	• Financial information has predictive value **if it can be used as an input to processes** employed by users **to predict future outcomes.** • Financial information with predictive value is employed by users in making their own predictions.
Confirmatory Value	• Financial information has confirmatory value **if it provides feedback about (confirms or changes)** previous evaluations.

The predictive value and confirmatory value are interrelated. Information that has predictive value often also has confirmatory value.

- For example, revenue information for the current year, which can be used as the basis for predicting revenues in future years, can also be compared with revenue predictions for the current year that were made in past years. The results of those comparisons can help a user to correct and improve the processes that were used to make those previous predictions.

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The relevance of information is affected by its **nature** and its **materiality**.

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. • 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 (Para 2.12 onwards)

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 substance of the phenomena that it purports to represent.

In many circumstances, the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon.

To be a perfectly faithful representation below 3 characteristics need to be present.

A) Complete
B) Neutral
C) Free from error

Completeness	• A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. • *Ex: a complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all the assets in the group, and a description of what the numerical depiction represents (for example, historical cost or fair value)*
Neutrality	• Not being bias in the selection or presentation of financial information. • A neutral depiction is not slanted, weighted, emphasized, de emphasized or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users.

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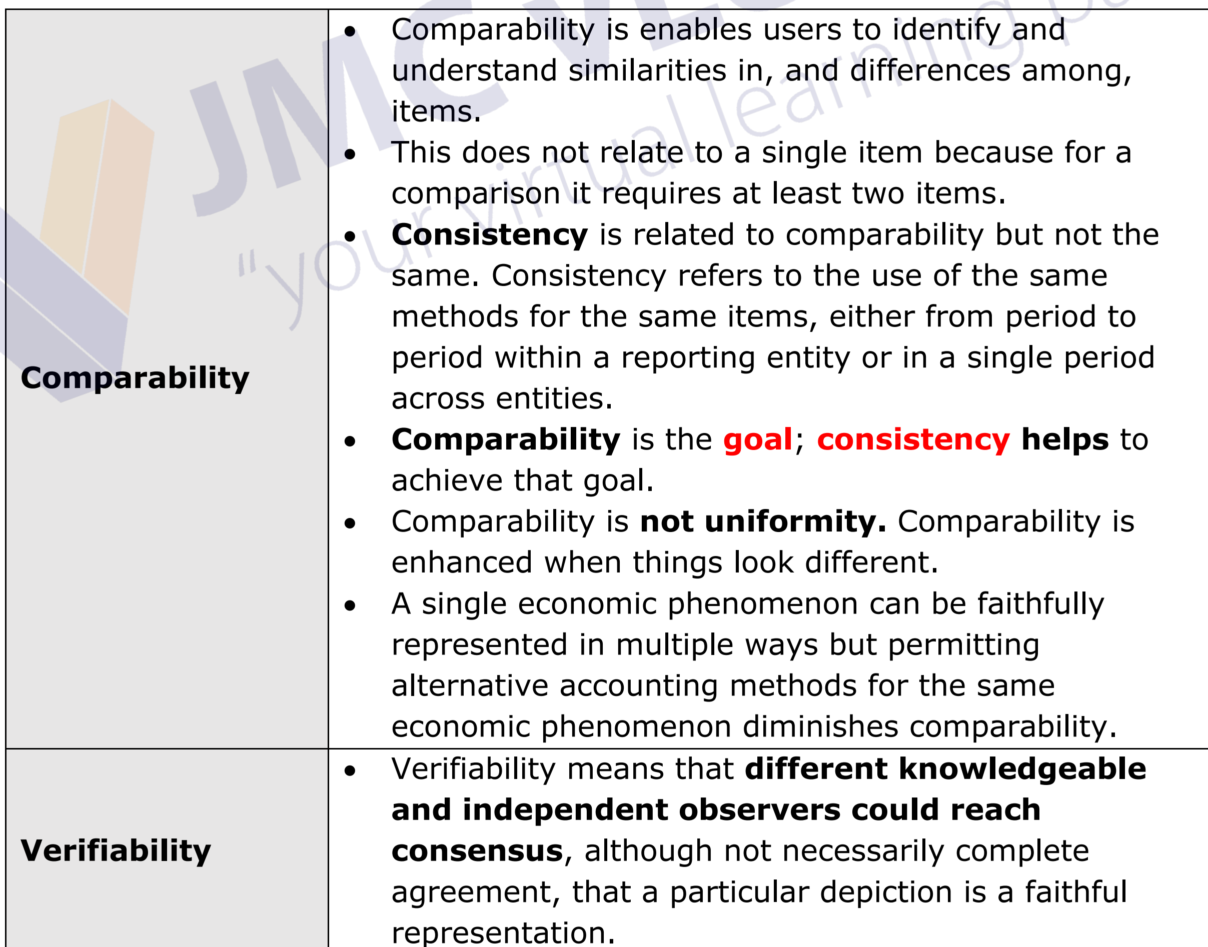
Free from error	• Free from error means there are **no errors or omissions in the description of the phenomenon**, and the process used to produce the reported information has been selected and applied with no errors in the process. • Free from error does not mean perfectly accurate in all respects.

Substance over form (ie representing the economic substance of a transaction rather than its legal form in the financial statements) is **not a separate qualitative characteristic** under the Conceptual Framework. The IASB says that the application of substance over form is required in order to achieve a faithful representation. Faithful representation of a transaction is only possible if it is accounted for according to its substance and economic reality.

Enhancing Qualitative Characteristics (Para 2.12 onwards)

Comparability, verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of information that both is relevant and provides a faithful representation of what it purports to represent.



Comparability	• Comparability is enables users to identify and understand similarities in, and differences among, items. • This does not relate to a single item because for a comparison it requires at least two items. • **Consistency** is related to comparability but not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. • **Comparability** is the **goal**; **consistency helps** to achieve that goal. • Comparability is **not uniformity.** Comparability is enhanced when things look different. • A single economic phenomenon can be faithfully represented in multiple ways but permitting alternative accounting methods for the same economic phenomenon diminishes comparability.
Verifiability	• Verifiability means that **different knowledgeable and independent observers could reach consensus**, although not necessarily complete agreement, that a particular depiction is a faithful representation.

	• Verification can be direct or indirect. ○ Direct verification means verifying an amount or other representation through **direct observation**. Ex- counting cash ○ Indirect verification means **checking the inputs** to a model, formula or other technique and recalculating the outputs using the same methodology. Ex- Recalculating inventory cost using FIFO.
Timeliness	• Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. • Older the information is the less useful it is.
Understandability	• Classifying, characterizing and presenting information clearly and concisely makes it understandable. • Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena

The cost constraint on useful financial reporting (Para 2.39 onwards)

Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

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Chapter 03 - Financial statements and the reporting entity

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

That information is provided:

a. in the statement of financial position, by recognizing assets, liabilities and equity:
b. in the statement(s) of financial performance by recognizing income and expenses; and
c. in other statements and notes, by presenting and disclosing information about:

i. recognized assets, liabilities, equity, income and expenses (including information about their nature and about the risks arising from those recognized assets and liabilities;
ii. assets and liabilities that have not been recognized (see paragraph 5.6), including information about their nature and about the risks arising from them;
iii. cash flows;
iv. contributions from holders of equity claims and distributions to them; and
v. the methods, assumptions and judgements used in estimating the amounts presented or disclosed, and changes in those methods, assumptions, and judgements.

Reporting period

Financial statements are prepared for a specified period of time (reporting period) and provide information about:

(a) assets and liabilities—including unrecognized assets and liabilities—and equity that existed **at the end of the reporting period**, or during the reporting period; and
(b) income and expenses **for the reporting period.**

To help users of financial statements to identify and assess changes and trends, financial statements also provide comparative information for at least one preceding reporting period.

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Going concern assumption (The underlying assumption)

Financial statements are normally prepared on the assumption that the reporting entity is a going concern and **will continue in operation for the foreseeable future**. Hence, it is assumed that the entity has neither the intention nor the need to enter liquidation or to cease trading. If such an intention or need exists, the financial statements may have to be prepared on a different basis. If so, the financial statements describe the basis used.

The reporting entity

A reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be:

- a single entity or;
- a portion of an entity or
- can comprise more than one entity.

A reporting entity **is not necessarily a legal entity**.

Scenario	Reporting entity's financial statements are referred to as
If a reporting entity comprises both the parent and its subsidiaries	Consolidated financial statements
If a reporting entity is the parent alone	Unconsolidated financial statements
If a reporting entity comprises two or more entities that are not all linked by a parent-subsidiary relationship	Combined financial statements

Chapter 04 - The elements of financial statements

The elements of financial statements defined in the Conceptual Framework are:

(a) **assets**, **liabilities** and **equity**, which relate to a reporting entity's financial position; and
(b) **income** and **expenses**, which relate to a reporting entity's financial performance.

Item discussed in Chapter 1	Element	Definition or description
Economic resource	Asset	A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.
Claim	Liability	A present obligation of the entity to transfer an economic resource as a result of past events.
	Equity	The residual interest in the assets of the entity after deducting all its liabilities.
Changes in economic resources and claims, reflecting financial performance	Income	Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

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	Expenses	Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.
Other changes in economic resources and claims	–	Contributions from holders of equity claims, and distributions to them.
	–	Exchanges of assets or liabilities that do not result in increases or decreases in equity.

Asset

An asset is a present **economic resource** controlled by the entity as a result of past events.

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

Rights that have the potential to produce economic benefits take many forms, including:

A. rights that correspond to an obligation of another party, for example:
   i. rights to receive cash.
   ii. rights to receive goods or services.
   iii. rights to exchange economic resources with another party on favourable terms. Such rights include, for example, a forward contract to buy an economic resource on terms that are currently favourable or an option to buy an economic resource.
   iv. rights to benefit from an obligation of another party to transfer an economic resource if a specified uncertain future event occurs.

B. rights that do not correspond to an obligation of another party, for example:
   i. rights over physical objects, such as property, plant and equipment or inventories. Examples of such rights are a right to use a physical object or a right to benefit from the residual value of a leased object.
   ii. rights to use intellectual property.

For the **potential to produce economic benefits** to exist, they do not need to be certain or even likely (ie there may be a low probability). This low probability will, however, affect whether the asset is recognised and how it is measured.

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An economic resource could produce economic benefits for an entity by entitling or enabling it to do, for example, one or more of the following:

(a) receive contractual cash flows or another economic resource;
(b) exchange economic resources with another party on favourable terms;
(c) produce cash inflows or avoid cash outflows by, for example:
(d) using the economic resource either individually or in combination with other economic resources to produce goods or provide services;
(e) using the economic resource to enhance the value of other economic resources; or
(f) leasing the economic resource to another party;
(g) receive cash or other economic resources by selling the economic resource; or
(h) extinguish liabilities by transferring the economic resource.

An entity **controls** an economic resource if it has the present **ability to direct the use** of the economic resource and **obtain the economic benefits** that may flow from it. Control includes the present **ability to prevent other parties from directing the use** of the economic resource and from obtaining the economic benefits that may flow from it. It follows that, if one party controls an economic resource, no other party controls that resource.

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Liability

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

For a liability to exist, three criteria must all be satisfied:

A) the entity has an obligation
B) the obligation is to transfer an economic resource
C) the obligation is a present obligation that exists as a result of past events

Obligation	• An obligation is a duty or responsibility that an entity has no practical ability to avoid. • Obligations are two types. A. **Legal obligations** - established by contract, legislation or similar means and are legally enforceable. B. **Constructive obligation** - from an entity's customary practices, published policies or specific statements.

Transfer of an economic resource	• The obligation must have the potential to require the entity to transfer an economic resource to another party. • Obligations to transfer an economic resource include, for example: (a) obligations to pay cash. (b) obligations to deliver goods or provide services. (c) obligations to exchange economic resources with another party on unfavourable terms. Such obligations include, for example, a forward contract to sell an economic resource on terms that are currently unfavourable or an option that entitles another party to buy an economic resource from the entity. (d) obligations to transfer an economic resource if a specified uncertain future event occurs. (e) (e) obligations to issue a financial instrument if that financial instrument will oblige the entity to transfer an economic resource.
Present obligation as a result of past events	• A present obligation exists as a result of past events only if: (a) the entity has already obtained economic benefits or taken an action; and (b) as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.

Equity

Equity is the **residual interest** in the assets of the entity after deducting all its liabilities.

Equity claims are claims on the residual interest in the assets of the entity after deducting all its liabilities. In other words, they are claims against the entity that do not meet the definition of a liability. Such claims may be established by contract, legislation or similar means, and include, to the extent that they do not meet the definition of a liability:

(a) shares of various types, issued by the entity; and
(b) some obligations of the entity to issue another equity claim.

Different classes of equity claims, such as ordinary shares and preference shares, may confer on their holders different rights, for example, rights to receive some or all of the following from the entity:

(a) dividends, if the entity decides to pay dividends to eligible holders;

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(b) the proceeds from satisfying the equity claims, either in full on liquidation, or in part at other times; or
(c) other equity claims

Income

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

Expenses

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

It follows from these definitions of income and expenses that contributions from holders of equity claims are not income, and distributions to holders of equity claims are not expenses.

Question no 1

Wealth Management (Pvt) Ltd ("Wealth") enters into a legal arrangement to act as a trustee for Prudent (Pvt) Ltd ("Prudent") by holding listed shares on Prudent's behalf. Prudent will make all investment decisions, and Wealth will act according to Prudent's instructions. Wealth will earn a trustee fee for holding the shares.

The following statement was made by the accounts executive of Wealth:

"Since the investments in shares held by Wealth, those investments shall be recorded in the books of Wealth".

Required:

Assess the above statement with reference to Conceptual Framework for Financial Reporting.

Chapter 05 - Recognition and derecognition

Recognition is the process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition. Recognition involves depicting the item in one of those statements—either alone or in aggregation with other items—in words and by a monetary amount and including that amount in one or more totals in that statement.

The amount at which an asset, a liability or equity is recognized in the statement of financial position is referred to as its '**carrying amount**'.

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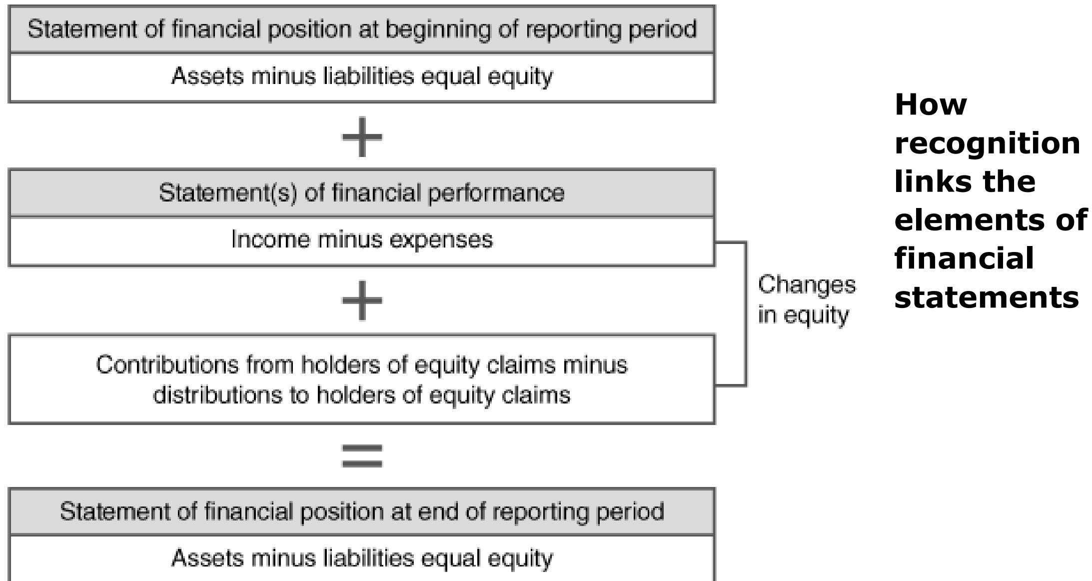

How recognition links the elements of financial statements

The initial recognition of assets or liabilities arising from transactions or other events may result in the simultaneous recognition of both income and related expenses. For example, the sale of goods for cash results in the recognition of both income (from the recognition of one asset—the cash) and an expense (from the derecognition of another asset—the goods sold).

Recognition criteria

1. Meets the **definition** of the element.
2. Provides **relevant information** about the asset or liability and about any resulting income, expenses or changes in equity.
3. Provides a **faithful representation** of the asset or liability and of any resulting income, expenses or changes in equity.
4. **Benefit** of recognizing the element exceeds the cost of recognition of that element.

Relevance	Recognition of an element **may not provide** relevant information when: 1. it is uncertain whether an asset or liability exists **(existence uncertainty)** 2. an asset or liability exists, but the **probability** of an inflow or outflow of economic benefits is **low**.
Faithful representation	Faithful representation can is affected by the level of **measurement uncertainty** associated with element.

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Question no 2

iSecurity PLC is a consultancy firm which provides consultancy services in relation to information technology (IT) security to corporates. Recently the management of the company has taken following decisions:

i. Three employees of the company were sent to Singapore for IT security training in order to develop their job-related skills. The total expenses incurred for this training were Rs. 1.2 million. The management has decided to capitalize these expenses as they will give rise to future economic benefits to the company.

ii. The company has raised a purchase order (PO) for procuring three modern laptops. The laptops will be available to the company only after the financial year end. The management has decided to recognise a liability at the year-end for the purchase of these laptops. Recently a new member was appointed to the company's board of directors. He has complained at a board meeting regarding the non-availability of timely information from the management.

Required:

Discuss the decisions taken by the management in (i) and (ii) above with reference to the 'Conceptual framework for Financial Reporting'.

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Question no 3

Dress (Pvt) Ltd ("DPL") is engaged in designing dresses for ladies. You have been provided with the following information relating to the financial year ended 31 March 2023.

i. DPL has an employee who is extraordinarily creative in designing dresses. The company pays a very high salary and other benefits to retain him. The annual cost incurred by DPL for this employee is Rs. 20 million.

ii. DPL sued a supplier claiming the damages caused by the low-quality materials provided by this supplier. DPL expects to receive Rs. 10 million for the damages. The company's lawyer has advised that it is virtually certain that DPL will receive the damages claimed.

Required:

Per the Conceptual Framework for Financial Reporting assess whether each of the above should be recognized as an asset in the financial statements of DPL.

Derecognition

Derecognition is the removal of all or part of a recognized asset or liability from an entity's statement of financial position. Derecognition normally occurs when that item no longer meets the definition of an asset or of a liability:

(a) for an asset, derecognition normally occurs when the entity **loses control** of all or part of the recognized asset; and
(b) for a liability, derecognition normally occurs when the **entity no longer has a present obligation** for all or part of the recognized liability.

Chapter 06 – Measurement

Elements recognized in financial statements are quantified in monetary terms. This requires the selection of a measurement basis. Consideration of the qualitative characteristics of useful financial information and of the cost constraint is likely to result in the selection of different measurement bases for different assets, liabilities, income and expenses.

<table>
<tr><td>Historical cost</td><td colspan="2">Historical cost measures provide monetary information about assets, liabilities and related income and expenses, from the price of the transaction or other event that gave rise to them.
Historical cost does not reflect changes in values.
Comprising the consideration paid to acquire or create the asset plus transaction costs.
In some cases, a current value of the asset or liability is used as a deemed cost on initial recognition.</td></tr>
<tr><td rowspan="2">Current Value</td><td colspan="2">Current value measures provide monetary information about assets, liabilities and related income and expenses, using information updated to reflect conditions at the measurement date.
There are three current value measurement bases.
A. Fair Value
B. Value in use for assets and fulfilment value for liabilities
C. Current cost</td></tr>
<tr><td>Fair Value</td><td>Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.
Fair value can be determined directly by observing prices in an active market. In other cases, it is determined indirectly using measurement techniques</td></tr>
</table>

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	Value in use and fulfilment value	• Value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal. • Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability.
	Current cost	• The current cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date. • The current cost of a liability is the consideration that would be received for an equivalent liability at the measurement date minus the transaction costs that would be incurred at that date.

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Question no 4

A machine was purchased on 1 March 2022 at a cost of Rs. 3m. It has a useful life of ten years and there had been not any impairment implication relation to this asset. This machine is not too specialized, and the current market price of the machine is Rs. 2m.

Further, the machine has a scrap value of Rs. 100,000 and is expected to generate Rs. 500,000 per annum for the remaining 8 years of its life and if the company's cost of capital is 10%.

Required:

Identify and explain the measurement methods as per conceptual framework in relation to the above asset.

Chapter 08 – Concepts of capital and capital maintenance

There are two capital concepts are identified.

Financial concept of capital	• Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity. • Is adopted by most entities in preparing their financial statements
Physical concept of capital	• Operating capability, capital is regarded as the productive capacity of the entity based on.

Accordingly, two capital maintenance concepts are also identified.

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 period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power
Physical Capital Maintenance	Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed 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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Question no 5

P (Pvt) Ltd has a property that is used partly for administrative purposes. The other part, which can be sold separately, has been given on rent. This property has been reflected in the financial statements as property, plant and equipment and all the disclosures required by LKAS 16, Property, Plant and Equipment have been made.

Required:

Discuss whether the above property has been faithfully represented in the financial statements as required by the Conceptual Framework for Financial Reporting.

SLFRS 13 - Fair Value Measurement

Topic No 02

SLFRS 13 Fair value measurement provides guidance on determining fair value where other standards require an item to be measured at fair value.

Can be applied to:

- LKAS 16 Property, plant and equipment
- LKAS 40 Investment property
- LKAS 41 Agriculture
- SLFRS 09 Financial instruments

SLFRS 13 does not, however, apply to the measurement of fair value in respect of the following:

A) Share-based payment transactions within the scope of SLFRS 2 Share-based payment,
B) Leasing transactions within the scope of LKAS 17 Leases; and
C) Net realizable value as in LKAS 2 Inventories; or value in use as in LKAS 36 Impairment of assets.

In each of these cases, the relevant standard provides the required guidance.

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Definition of Fair Value

Fair value is defined as:

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

This is an exit price, ie the price that an entity disposing of an asset or liability would achieve rather than the price that an entity acquiring an asset or liability would have to pay.

Measurement

Fair value is a market-based measurement, **not an entity-specific measurement**. Therefore, fair value is measured using the assumptions that market participants would use when pricing the asset under current market conditions, taking into account any relevant characteristics of the asset.

Therefore, whether an entity intends to hold an asset or settle a liability is irrelevant when measuring fair value.

A fair value measurement requires an entity to determine:

A) The item being measured.
B) For a non-financial asset, the highest and best use of the asset and whether the asset is used in combination with other assets.
C) The market in which an orderly transaction would take place for the asset or liability.
D) The appropriate valuation technique to use when measuring fair value.

The item being measured (The asset or liability)

A fair value measurement is for a particular asset or a liability. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include:

A) the condition and location of the asset; and
B) restrictions, if any, on the sale or use of the asset.

The item for which fair value is determined is referred to in SLFRS 13 as the **'unit of account'**. It is defined as the level at which an asset or liability is aggregated or disaggregated in an SLFRS for accounting purposes. The unit of account can be either of following.

A) a standalone asset or liability (e.g., a financial instrument or a non-financial asset); or
B) a group of assets, a group of liabilities or a group of assets and liabilities (e.g., a cash generating unit or a business).

Example: Unit of Account

A premium or discount on a large holding of the same shares (because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity) is not considered when measuring fair value: the quoted price per share in an active market is used.

However, a control premium is considered when measuring the fair value of a controlling interest, because the unit of account is the controlling interest. Similarly, any non-controlling interest discount is considered where measuring a non-controlling interest.

Application to non-financial assets

Highest and best use

In the case of non-financial assets, fair value is determined based on the highest and best use of the asset from the **perspective of a market participant** (not the entity's perspective).

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The highest and best use should be:

- **Physically possible** - Physical characteristics of the asset that market participants would take into account when pricing the asset (eg the location or size of a property)

- **Legally permissible** - Legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property)

- **Financially feasible** - whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

In many cases, it can be assumed that the current use of an asset is its highest and best use.

Example: highest and best use

An entity acquires land that is currently developed for industrial use as a site for a factory. Nearby sites have recently been developed for residential use as sites 0r high-rise apartment buildings. On the basis of that evidence, the entity believes that the land could be developed for residential use.

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

- The value of the land as currently developed for industrial use, or
- The value of the land as a vacant site for residential use taking into account the costs of demolishing the factory and other costs to convert the land to a vacant site.

The market

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

A) In the **principal marke**t for the asset or liability, or
B) In the absence of a principal market, in the **most advantageous market** for the asset or liability.

The principal market is the market with the greatest volume and level of activity for that asset or liability. If a principal market exists, then the price in that market must be used to establish fair value.

The most advantageous market is the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to

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transfer the liability after taking into account transaction and transport costs. Although transaction costs are taken into account when determining the most advantageous market, fair value once determined is not adjusted for these costs.

A) In most cases, the principal market and the most advantageous market will be the same.
B) It is presumed that the market in which an entity normally transacts is the principal or most advantageous market, unless there is evidence to the contrary.

It is important to note that although an entity must be able to access the market, the entity does not need to be able to sell the particular asset or transfer the particular liability on the measurement date to be able to measure fair value on the basis of the price in that market.

The Price

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (ie an **exit price**) regardless of whether that price is directly observable or estimated using another valuation technique.

Points to note in determining the price.

- In determining the price **Transaction Costs** shall not be adjusted.
    - Transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction and will differ depending on how an entity enters into a transaction for the asset or liability.

- In determining the price **Transport Costs** shall be considered.
    - If location is a characteristic of the asset (as might be the case, for example, for a commodity), the price in the principal (or most advantageous) market shall be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to that market.

Question 01

An asset is sold in two active markets, Market A and Market B, at Rs. 98 and Rs. 97, respectively. Alutwewa Plantations PLC does business in both markets and can

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access the price in those markets for the asset at the measurement date as follows.

	Market A (Rs.)	Market B (Rs.)
Price	98	97
Transaction costs	(4)	(3)
Transport costs (to transport the asset to that market)	(4)	(2)
	90	92

Required:

1. What is the fair value of the asset if Market A is the principal market?
2. What is the fair value of the asset if neither Market A nor Market B is the principal market?

Valuation Techniques

SLFRS 13 does not require the use of a particular valuation technique, however it does require a technique that is 'appropriate in the circumstances' and that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs.

The standard discusses three widely used valuation techniques:

The market approach	The cost approach	The income approach
A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. Ex: Using market multiples	A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset. (Referred to as current replacement cost) This method is mostly used to measure the fair value of tangible assets that are used in combination with other assets or with other assets and liabilities.	A valuation technique that converts future amounts (e.g., cash flows or income) to a single discounted amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

Whichever valuation technique is selected, it should be applied consistently from period to period. Revisions resulting from a change in the valuation technique or

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its application shall be accounted for as a change in accounting estimate in accordance with LKAS 8.

Question 02 - ACCA

Baklava has an investment property that is measured at fair value. This property is rented out on short-term leases.

The directors wish to fair value the property by estimating the present value of the net cash flows that the property will generate for Baklava. They argue that this best reflects the way in which the building will generate economic benefits for Baklava.

The building is unique, although there have been many sales of similar buildings in the local area.

Required:

Discuss whether the valuation technique suggested by the directors complies with International Financial Reporting Standards.

Inputs to Valuation Techniques

The standard requires that in any valuation technique, the use of relevant observable inputs should be maximized, and unobservable inputs minimized. To increase consistency and comparability in fair value measurements and related disclosures, SLFRS 13 establishes a fair value hierarchy that categorizes into three levels the inputs to valuation techniques used to measure fair value.

The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

Level 1	• Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date. • Provides most reliable evidence.
Level 2	• Inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. • If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. • Examples, ○ Quoted prices for similar assets or liabilities in active markets

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	○ Quoted prices for identical or similar assets or liabilities in markets that are not active ○ Inputs other than quoted prices that are observable ▪ Interest rates and yield curves ▪ Credit spreads
Level 3	• Inputs are unobservable inputs for the asset or liability. • Shall be used to measure fair value to the extent that relevant observable inputs are not available.

Note following.

- The fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques used to measure fair value.
  - For example, a fair value measurement developed using a present value technique might be categorized within Level 2 or Level 3, depending on the inputs that are significant to the entire measurement and the level of the fair value hierarchy within which those inputs are categorized.

- If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorized within Level 3 of the fair value hierarchy.

An item's fair value is categorized according to the lowest level input. Therefore, a fair value measurement of quoted shares based on the unadjusted share price is a Level 1 measurement, whereas a fair value measurement of an unquoted investment using a valuation technique based on discounted cash flows is a Level 3 measurement.

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Example of inputs

	Asset	Example
Level 1	Equity shares in a listed entity	Unadjusted quoted prices in an active market
Level 2	Building held and used	Price per square meter for the building from observable market data, such as observed transactions for similar buildings in similar locations.
Level 3	Cash-generating unit	Profit or cash flow forecast using own data

Measurement of Financial Instruments

Financial Assets

The following should be considered where a financial asset is being fair valued.

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

B) In the case of equity shares, a control premium is considered when measuring the fair value of a controlling interest. Similarly, any non-controlling interest discount is considered where measuring a non-controlling interest.

C) The valuation of unlisted equity investments involves significant judgement, and different valuation techniques are likely to result in different fair values, however this does not mean that any of the techniques are incorrect. Certain techniques are better suited to particular types of business, for example an asset-based approach is relevant to property companies while an income approach is more relevant to service businesses. It is likely that valuation will be based on some unobservable inputs and as a result the overall fair value will be classified as a Level 3 measurement.

Liabilities and Own Equity Instruments

Liabilities and own equity instruments (e.g. equity interests issued as consideration in a business combination) must be measured on the assumption that the liability or equity is transferred to a market participant at the measurement date and therefore:

A) A liability would remain outstanding, and the market participant would be required to fulfil the obligation.

B) An entity's own equity instrument would remain outstanding, and the market participant would take on the rights and responsibilities associated with the instrument This differs (sometimes significantly so) from a measurement that is based on the assumption of settlement of a liability or cancellation of an entity's own equity instrument.

SLFRS 13 further requires that the fair value of a liability must factor in nonperformance risk. Anything that could influence the likelihood of an obligation being fulfilled is considered a non-performance risk. This could include the risk of physically extracting or transporting an asset or the entity's own credit risk. The

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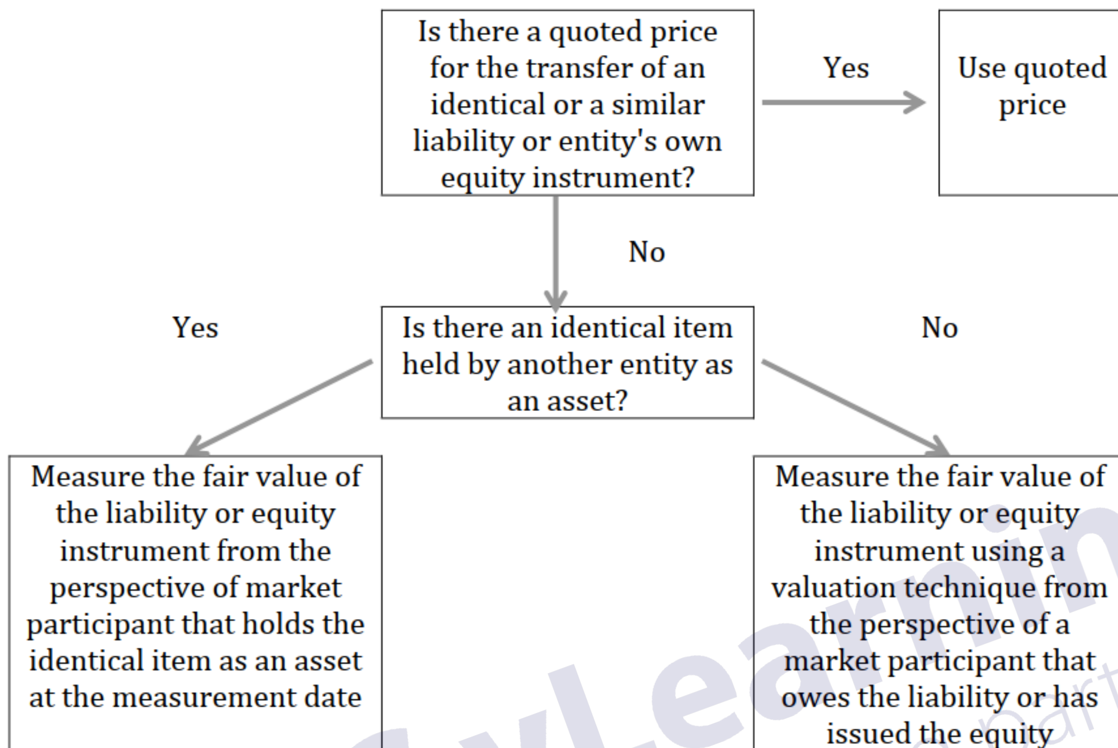
specific approach to fair value liabilities and an entity's own equity instruments sometimes differs from the concepts to fair value an asset and is summarized in the following flowchart.



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Disclosure

An entity should disclose information that helps users of the financial statements assess both of the following.

A) For assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements.

B) For recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

Question 03

(a) "Fair value is a market-based measurement, not an entity-specific measurement; also, fair value reflects the current market condition."

Required:

(a) Describe the different levels of inputs explained in SLFRS 13 - Fair Value Measurement, in measuring fair value.
(b) According to SLFRS 13, state the three (03) different approaches that can be used to derive the fair value.

(b) ABC (Pvt) Ltd (ABC) is a real estate company, specializing in industrial property development. ABC measures its industrial investment property using the fair value method. Fair value is arrived at using the estimated value to be incurred to build similar kind of investment property less any obsolescence. A member of the finance division conducts valuations. Obsolescence is determined based on the age of the property and the nature of its use. Sale prices for a similar kind of investment property in a similar location, as well as market rent data for similar kind of industrial property are also available.

Required:

(a) Comment on the method used by ABC in measuring the fair value of its industrial investment property.

Question 04

Yellow owns several farms and owns a division which sells agricultural vehicles. It is considering selling this agricultural retail division and wishes to measure the fair value of the inventory of vehicles for the purpose of the sale. Three markets currently exist for the vehicles. Yellow has transacted regularly in all three markets. At 30 April 2015, Yellow wishes to find the fair value of 150 new vehicles, which are identical. The current volume and prices in the three markets are as follows:

Market	Sales Price per vehicle (USD)	Historical Volume (No of vehicles sold by yellow)	Total volume of vehicles sold in the market	Transaction cost per vehicle (USD)	Transport cost to the market per vehicle (USD)
Europe	40,000	6,000	150,000	500	400
Asia	38,000	2,500	750,000	400	700
Africa	34,000	1,500	100,000	300	600

Yellow wishes to value the vehicles at $39,100 per vehicle as these are the highest net proceeds per vehicle, and Europe is the largest market for Yellow product.

Required:

(a) Comment on the method used by Yellow in measuring the fair value of Agricultural Vehicles.

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Question 05

Multi PLC measures its properties at fair value and such properties include land and building classified as property, plant and equipment and investment properties. The finance director is unhappy about the valuations carried out as at 31 March 2023. The details of such valuations for each property are as follows.

(a) (Kadawatha property (land) – a donor has given this land to Multi PLC to construct a walking path and a play area for children in 2016. The donor has specified in the title transfer documents that the land should be used only for this purpose even if the land is sold to another party. The adjoining land was sold closer to the year-end at Rs. 600,000 per perch. Multi PLC valued the land using this price per perch.

(b) Kelaniya property (land) – this land is located closer to the Kelaniya river and was affected by floods during the heavy rain seasons. Due to the unavailability of recent prices of nearby lands, the per perch price of Rs. 1 million pertaining to a recently sold land in Kelaniya facing the Colombo-Kandy main road was used in valuing this land of Multi PLC.

Required:

1. Evaluate each of the above valuations in accordance with the principles set out in SLFRS 13, Fair value measurement.

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Question 06 - December 2023

HN acquired a land in Ekala. This land has been developed for industrial use as a site for a factory. In the recent past, land in this area has been redeveloped for residential use as sites for housing schemes. On that basis, HN believes that this land could be developed for residential purposes. The following information is available.

- The fair value of the land as currently developed for industrial purposes is Rs. 100 million.
- The fair value of the land as a vacant site for residential use is Rs. 120 million.
- Cost of demolishing the factory and other costs to convert the land to a vacant site: Rs. 25 million

Required:

Calculate the fair value of the land in Ekala by applying the highest and best use concept per SLFRS 13 Fair Value Measurement.

LKAS 36 – Impairment of Assets

Topic No 03

Introduction

Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. Recoverable amount is the higher of its fair value less costs of disposal and its value in use.

There is an established principle that assets should not be carried at above their recoverable amount. An entity should write down the carrying amount of an asset to its recoverable amount if the carrying amount of an asset is not recoverable in full either through continued use or sale. LKAS 36 Impairment of assets puts in place a detailed methodology for carrying out impairment reviews and related accounting treatments and disclosures.

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The main accounting issues to consider are as follows.

(a) How is it possible to **identify when** an impairment loss may have occurred?
(b) How should the **recoverable amount** of the asset be measured?
(c) How should an 'impairment loss' be **recognized in the accounts**?

Scope of LKAS 36

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

- Inventories
- Assets arising from construction contracts
- Deferred tax assets

- Assets arising under LKAS 19 Employee benefits
- Financial assets within the scope of LKAS 32 Financial instruments: presentation
- Investment property measured at fair value (LKAS 40)
- Biological assets measured at fair value less costs to sell (LKAS 41)
- Non-current assets held for sale, which are dealt with under SLFRS 5 Noncurrent assets held for sale and discontinued operations.

Definitions

Impairment Loss	An impairment loss is the amount by which the carrying amount of an asset or cash-generating unit exceeds its recoverable amount.
Carrying Amount	Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.
Recoverable Amount	The recoverable amount of an asset or a cash generating unit is the higher of its fair value less costs of disposal and its value in use.
Fair Value	Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Costs Of Disposal	Costs of disposal are incremental costs directly attributable to the disposal of an asset or cash generating unit, excluding finance costs and income tax expense.
Value In Use	Value in use is the present value of the future cash flows expected to be derived from an asset or cash generating unit

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Identifying an asset that may be impaired

An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. Standard does not require an entity to make a formal estimate of recoverable amount if no indication of an impairment loss is present unless a compulsory testing is required by the same standard.

For this also the concept of materiality applies, and only material impairment needs to be identified. If there are indications of possible impairment, the entity is required to conduct an impairment test.

Even if there are no indications of impairment, the following assets must always be tested for impairment annually.

A. An intangible asset with an indefinite useful life

B. An intangible asset that is not yet available for use
C. Goodwill acquired in a business combination

Impairment testing of intangible assets must take place at the same time every year; however, there is no need for this to be at the reporting date. In the year in which an intangible asset was initially recognized, it must be tested for impairment before the end of that year.

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a **minimum**, the following **indications**:

External Sources of Information
(a) A fall in the asset's market value that is more significant than would normally be expected from passage of time over normal use.
(b) A significant change in the technological, market, legal or economic environment of the business in which the assets are employed.
(c) An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use.
(d) The carrying amount of the entity's net assets being more than its market capitalization.

Internal Sources of Information
(e) Evidence of obsolescence or physical damage of an asset.
(f) Adverse changes in the use to which the asset is put, eg the asset becoming idle, plans to dispose of an asset early or plans to discontinue the part of a business that uses the asset.
(g) Worse than expected economic performance of the asset.
(h) Evidence from internal reporting such as: • Cash flows for operating/maintaining the asset those are significantly higher than originally budgeted. • Net cash flows or operating profit/loss that is significantly worse than budgeted. • A significant decline in budgeted net cash flows or operating profit flowing from the asset. • Operating losses or net cash outflows when current periods are aggregated with budgeted amounts for the future
(i) for an investment in a subsidiary, joint venture or associate, the investor recognizes a dividend from the investment and evidence is available that:

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- the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or
- the dividend exceeds the total comprehensive income of the subsidiary, joint venture or associate in the period the dividend is declared

The Impairment Test

Testing for impairment involves determining an asset's recoverable amount and comparing this with the asset's carrying amount.

Calculation of impairment loss

An impairment loss arises where carrying amount exceeds recoverable amount, which is the higher of value in use and fair value less costs of disposal. In this case, carrying amount is written down to recoverable amount and the write down is recognized as an impairment loss.

Therefore, testing for impairment involves establishing recoverable amount. As recoverable amount is the higher of value in use and fair value less costs of disposal, if either of these amounts exceeds an asset's carrying amount, the asset is not impaired and there is no need to determine the other amount.

Question 01

In each of the following situations, **identify** whether the asset is impaired.

(1) The carrying amount of a machine is Rs. 69,500. Its value in use is Rs. 68,500 and its fair value is Rs. 70,000. Costs of disposal are Rs. 600.

(2) The carrying amount of a property is Rs. 4.5m. The property could be sold on the open market for an estimated Rs. 5m subject to 10% agency fees. The value in use has been estimated at Rs. 4.4m.

Measuring fair value less costs of disposal

Fair value is established in accordance with the requirements of SLFRS 13 Fair value measurement. It is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

LKAS 36 provides no guidance on establishing fair value;

However; It does clarify that costs of disposal may include legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

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They do not, however, include termination benefits, nor costs associated with reducing or reorganizing a business following the disposal of an asset.

Measuring Value in Use

Value in use is the present value of the future cash flows expected to be generated by an asset. It must reflect:

(a) An estimate of the future cash flows the entity expects to derive from the asset.
(b) Expectations about variations in the amount and timing of future cash flows
(c) The time value of money
(d) The price for bearing the uncertainty inherent in the asset
(e) Other factors that would be reflected in pricing future cash flows from the asset Estimating value in use involves estimating cash flows to be derived from use (and disposal) of the asset and applying an appropriate discount rate.

Estimate of Cash Flows

The standard requires that:

(a) Cash flow projections are based on 'reasonable and supportable' assumptions.
(b) Projections of cash flows, normally up to a maximum period of five years, are based on the most recent budgets or financial forecasts.
(c) A steady or declining growth rate for each subsequent year (unless a rising growth rate can be justified) is used in extrapolating short-term projections of cash flows beyond this period. Unless a higher growth rate can be justified, the long-term growth rate employed should not be higher than the average long-term growth rate for the product, market, industry or country.

Cash flows should include:

- Projected cash inflows from continuing use of the asset
- Projected cash outflows necessary to generate these cash inflows
- Net cash flows from the disposal of the asset at the end of its life

They should not include:

- Cash flows associated with a future restructuring to which an entity is not committed.
- Cash flows associated with improving the asset's performance.
- Cash flows from financing activities
- Income tax receipts or payments

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Discount rate

The discount rate should be a current pre-tax rate (or rates) that reflect:

- The current assessment of the time value of money
- The risks specific to the asset

Impairment testing of an intangible asset with an indefinite useful life

An intangible asset with an indefinite useful life must be tested for impairment **annually**, regardless of whether there are indications of impairment.

As this requirement can be onerous to apply, LKAS 36 allows an entity to use the most recent detailed calculation of recoverable amount in a preceding period for the current period where:

(a) If the asset is tested for impairment as part of a cash-generating unit, the assets and liabilities making up that unit have not changed significantly since the most recent recoverable amount calculation.

(b) The most recently calculated recoverable amount exceeded the asset's carrying amount by a substantial margin.

(c) Events and circumstances that have occurred since the most recent recoverable amount calculation have been analyzed and there is only a remote likelihood that recoverable amount, if determined now, would be less than the asset's carrying amount.

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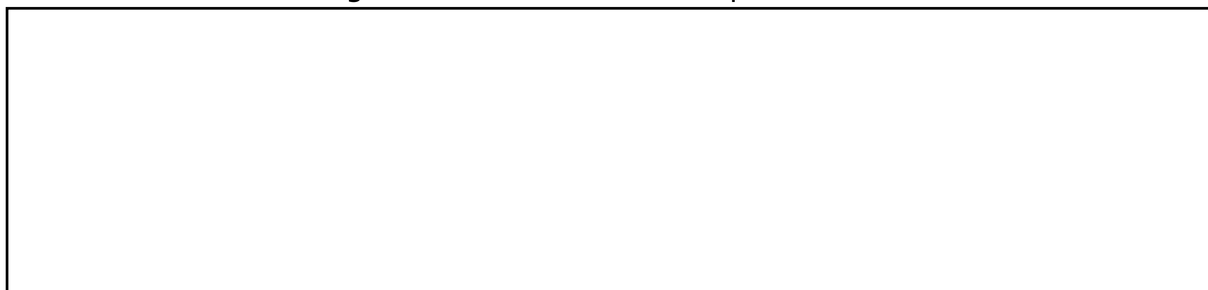
Accounting for Impairment

An impairment loss is recognized in **profit or loss** in the period when it arises.

Recognition of Impairment Loss

If the recoverable amount of an asset is less than its carrying amount, the asset is impaired and an impairment loss should be recognized. Impairment losses are normally recognized in profit or loss as they arise; however, where an impairment loss arises on a revalued asset, the impairment is treated as a revaluation decrease and first charged to the revaluation surplus.



Question 02

Fernando Property (Pvt) Ltd acquired a property on 1 January 20X4 at a cost of Rs. 8m and commenced depreciation over a 50-year useful life from this date. The company applied the LKAS 16 revaluation model for the subsequent accounting of the property, and revalued it for the first time to Rs. 8,544,000 at 31 December 20X5, continuing to depreciate it over the original term. During 20X6 there was a commercial property crash, and as a result the recoverable amount of the property fell to Rs. 7.4m at 31 December 20X6. Fernando Property do not make an annual reserves transfer in respect of revalued property.

Required:

Demonstrate how the impairment at 31 December 20X6 is accounted for.

Question 03

A company that extracts natural gas and oil has a drilling platform in the Caspian Sea. It is required by legislation of the country concerned to remove and dismantle the platform at the end of its useful life. Accordingly, the company has included an amount in its accounts for removal and dismantling costs, and is depreciating this amount over the platform's expected life.

The company is carrying out an exercise to establish whether there has been an impairment of the platform.

(a) Its carrying amount in the statement of financial position is Rs. 3m.
(b) The company has received an offer of Rs. 2.8m for the platform from another oil company. The bidder would take over the responsibility (and costs) for dismantling and removing the platform at the end of its life.
(c) The present value of the estimated cash flows from the platform's continued use is Rs. 3.3m (before adjusting for dismantling costs).
(d) The carrying amount in the statement of financial position for the provision for dismantling and removal is currently Rs. 0.6m.

Required:

Calculate the carrying amount of the drilling platform in the statement of financial position, and demonstrate how the impairment loss, if any, is accounted for.

Subsequent Accounting for an Impaired Asset

Subsequent to impairment, an asset continues to be depreciated, with the recoverable amount written off over the remaining useful life. The impairment

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testing rules of LKAS 36 are applied to all assets including those previously impaired and therefore further impairment tests are carried out at any later date where there are indications of impairment.

Cash-Generating Units (CGU)

Where the recoverable amount of an individual asset cannot be determined, it should be tested for impairment as part of the cash-generating unit to which it belongs.

Recoverable amount is determined for an individual asset as far as possible; however, where an asset does not generate cash flows that are independent of other assets, then recoverable amount must be determined for the cash-generating unit (CGU) to which the asset belongs.

A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. They should be identified consistently from period to period for the same asset, unless a change is justified.

Example: Cash-Generating Unit

A mining company owns a private railway to support its mining activities. The railway could only be sold for scrap value and does not generate cash flows that are largely independent of the cash inflows from the other assets of the mine. In this case, it is not possible to estimate the recoverable amount of the private railway because its value in use cannot be determined and is unlikely to be similar to scrap value. Therefore the entity estimates the recoverable amount of the CGU to which the private railway belongs (the mine) as a whole.

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Instances in which determining a CGU is unnecessary

There are two instances where the CGU of an asset does not have to be considered in order to determine whether that asset is impaired.

1. Where the asset's fair value less costs of disposal exceeds its carrying amount (ie there is no impairment), or

2. Where the asset's value in use can be estimated to be close to its fair value less costs of disposal and fair value less costs of disposal can be measured

Allocating assets to a CGU

An impairment loss in a CGU arises where its carrying amount exceeds its recoverable amount. The recoverable amount of a CGU is determined in the same way as the recoverable amount of an individual asset.

The carrying amount of a CGU is determined on a basis consistent with the way in which the recoverable amount of the CGU is determined, ie it includes those assets that will generate cash flows that are used in determining the CGU's value in use.

Corporate Assets

Corporate assets are those such as a head office that are used by more than one CGU. A portion of these should be allocated to the CGUs on a reasonable and consistent basis when determining the CGU's carrying amount, eg on the basis of the carrying amounts of the other non-current assets of each CGU.

Goodwill

Goodwill acquired in a business combination does not generate cash flows independently of other assets. It must be allocated to each of the acquirer's cash-generating units (or groups of cash-generating units) that is expected to benefit from the synergies of the combination. Each unit to which the goodwill is so allocated should:

1. Represent the lowest level within the entity at which the goodwill is monitored for internal management purposes.

2. Not be larger than a reporting segment determined in accordance with SLFRS 8 operating segments.

It may be impracticable to complete the allocation of goodwill before the first reporting date after a business combination, particularly if the acquirer is accounting for the combination for the first time using provisional values. The initial allocation of goodwill must be completed before the end of the first reporting period after the acquisition date.

Accounting for an Impairment Loss in a CGU

An impairment loss should be recognized for a CGU if (and only if) the recoverable amount of the CGU is less than the carrying amount in the statement of financial position. When an impairment loss is recognized for a cash-generating unit, the loss should be allocated between the assets in the unit in the following order.

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(a) First, to any assets that are obviously damaged or destroyed.
(b) Next, to the goodwill allocated to the cash generating unit.
(c) Then, to all other assets in the cash-generating unit, on a pro-rata basis

In allocating an impairment loss, the carrying amount of an asset **should not be reduced below the highest** of:

(a) Its fair value less costs of disposal
(b) Its value in use (if determinable)
(c) Zero

Question 04

A company has acquired another business for Rs. 4.5m: tangible assets are valued at Rs. 4m and goodwill at Rs. 0.5m. An asset with a carrying value of Rs. 1m is destroyed in a terrorist attack. The asset was not insured. The loss of the asset, without insurance, has prompted the company to assess whether there has been an impairment of assets in the acquired business and what the amount of any such loss is. The recoverable amount of the business (a single cash-generating unit) is measured as Rs. 3.1m.

Required:

Explain how the impairment should be recognized.

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Question 05

A cash-generating unit comprises the following (All are in Rs.Mn)

- Building 30
- Plant and equipment 6
- Goodwill 10
- Current assets 20

Following a recession, an impairment review has estimated the value in use of the cash-generating unit to be Rs. 50m and the fair value less costs of disposal to be Rs. 48m.

Required:

Demonstrate how the impairment loss is allocated.

Reversals of Impairment

In some circumstances, a previously recognized impairment loss may be reversed.

Individual Assets

Where impairment testing is carried out on a previously impaired asset, the recoverable amount may be higher than the asset's carrying amount. In this case, the previously recognized impairment loss is reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized.

The new carrying amount after the reversal cannot be higher than the carrying amount would have been (after the relevant depreciation) if the original impairment had not occurred. Subsequent depreciation is based on the new carrying amount, estimated residual value and estimated useful life.

Cash-generating Units

An impairment loss for goodwill is not reversed subsequent to recognition.

Question 06

A cash-generating unit comprising assets and associated purchased goodwill becomes impaired because the product it makes is overtaken by a technologically more advanced model produced by a competitor. The recoverable amount of the cash-generating unit falls to Rs. 80m, resulting in an impairment loss of Rs. 60m, allocated as follows.

	Carrying amount before depreciation (Rs.Mn)	Carrying amount after depreciation (Rs.Mn)
Goodwill	40	-
Current assets	20	20
Tangible non-current assets (market value Rs. 60m)	80	60
	140	**80**

After two years, the entity makes a technological breakthrough of its own. At this time the carrying amount of the tangible non-current assets of the CGU is Rs. 48m and the carrying amount of current assets is Rs. 25m and the recoverable amount of the cash-generating unit increases to Rs. 90m. The carrying amount of the tangible non-current assets had the impairment not occurred would have been Rs. 64m.

Required:

Calculate the reversal of the impairment loss.

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Disclosure

LKAS 36 has extensive disclosure requirements.

LKAS 36 requires that the following is disclosed in respect of impairments.

(a) The amount of impairment losses and reversals recognized in profit or loss in the period and the line item where they are recognized.

(b) The amount of impairment losses and reversals recognized in other comprehensive income in the period.

In addition, the following is disclosed for individual assets or CGUs for which a material impairment loss is recognized or reversed in the period:

(a) Events and circumstances leading to recognition of the loss or reversal
(b) The amount of loss or reversal recognized
(c) Details of the individual asset or CGU
(d) The recoverable amount and whether that is value in use or fair value less costs of disposal
(e) Details of how fair value is determined (where that is recoverable amount)
(f) Details of the discount rate used in value in use (where that is recoverable amount)

For the aggregate impairment losses and the aggregate reversals of impairment losses recognized during the period that are not material:

(a) The main classes of assets affected by impairment losses and reversals

(b) The main events and circumstances that led to the recognition of these impairment losses and reversals

In addition, detailed disclosure is required in respect of estimated used to measure recoverable amounts of CGUs containing goodwill or intangible assets with indefinite useful lives.

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Question 07

Canto acquired a cash-generating unit (CGU) several years ago but, at 28 February 2017, the directors of Canto were concerned that the value of the CGU had declined because of a reduction in sales due to new competitors entering the market. At 28 February 2017, the carrying amounts of the assets in the CGU before any impairment testing were (USD Mn):

Goodwill	3

Property, plant and equipment	10
Other assets	19
Total	**32**

The fair values of the property, plant and equipment and the other assets at 28 February 2017 were $10 million and $17 million respectively and their costs to sell were $100,000 and $300,000 respectively.

The CGU's cash flow forecasts for the next five years are as follows:

Date year ended	Pre-tax cash flow (USD Mn)	Post-tax cash flow (USD Mn)
28 February 2018	8	5
28 February 2019	7	5
28 February 2020	5	3
28 February 2021	3	1.5
28 February 2022	13	10

The pre-tax discount rate for the CGU is 8% and the post-tax discount rate is 6%. Canto has no plans to expand the capacity of the CGU and believes that a reorganization would bring cost savings but, as yet, no plan has been approved.

The directors of Canto need advice as to whether the CGU's value is impaired.

Required:

Advise the directors of Canto on how the above transactions should be dealt with in its financial statements with reference to relevant International Financial Reporting Standards.

Question 08 – 2020 December

Milanka PLC (Milanka) is a listed diversified entity, and you are the finance manager of the company. The following matters need to be properly addressed to finalize the financial reporting for the year ended 31 March 2020.

The carrying amounts of the assets of one cash-generating unit (CGU) of Milanka as at 31 March 2020 before impairment testing, and the fair value and cost to sell details of each asset category, are as follows.

Description	Carrying amount (Rs.)	Fair value (Rs.)	Cost to sell
Assets (Category A)	12,500,000	7,250,000	1% of fair value
Assets (Category B)	8,250,000	7,750,000	0.5% of fair value
Goodwill	3,500,000	-	-

The management decided to test the CGU for impairment as the demand for the service rendered through this unit has come down drastically due to technological obsolescence.

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The net cash inflow forecasts of the CGU for the next five years including the terminal value is as follows.

Year	2020/2021	2021/2022	2022/2023	2023/2024	2024/2025
Net cash inflow	5,500,000	4,275,000	3,875,000	2,568,000	6,257,000

The risk-adjusted pre-tax discount rate is 15% per annum. Further, Milanka strongly believes that the fair value less cost to sell of the CGU is limited to the aggregated fair values of the assets (Category A and Category B) subject to the respective costs to sell.

Required:

Advise the management of Milanka on the performance of the impairment test and the allocation of impairment results of the CGU.

Question 09 – 2021 June

NPA Capital PLC (NPA) is a listed, diversified entity and the following matters need to be addressed to finalise the financial statements for the year ended 31 March 2021.

The packaging segment of NPA suffered heavy losses during the current financial year. NPA considers this business segment as a separate cash generating unit (CGU). The net carrying values of the assets of the segment as at 31 March 2021 comprise the following.

- Building: Rs. 150 million
- Other plant and machinery: Rs. 50 million
- Goodwill: Rs. 60 million
- Inventory: Rs. 45 million
- Trade and other receivables: Rs. 65 million

On 31 March 2021, an impairment assessment was conducted, and the recoverable value of the CGU, determined to include all of the assets mentioned above, was estimated to be Rs. 290 million.

Required:

Assess the carrying amounts of the assets of the packaging segment as at 31 March 2021, considering the results of the impairment assessment referred.

Question 10 – 2023 June

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The finance team of XYZ (Pvt) Ltd (XYZ) is in the process of finalising its financial statements for the year ended 31 March 2023. They are currently discussing the following matters.

Impairment indicator assessment

The accountant has gathered information about the following cash generating units (CGUs).

- Medical Equipment Unit
  - This unit includes non-amortizing licenses (intangible assets) but no goodwill.
  - The performance of the unit exceeds the initial expectation.

- Hotel Unit
  - This unit does not include intangible assets or goodwill.
  - A significantly adverse future performance is expected from this unit.

- Automobile Unit
  - This unit does not include goodwill
  - The unit has invested a significant amount in a project and has correctly capitalized all expenses as an intangible asset. Amortization of this intangible asset is yet to commence.

Impairment test

The finance team of XYZ correctly assessed that the Transport Unit (another CGU of the company), requires an impairment test as at 31 March 2023.

This CGU comprises the following.

Asset	Buildings	Motor Vehicles	Goodwill	Inventories	Trade receivables	Total
Carrying value (Rs. million)	100	200	30	10	15	355

Required:

(a) Based on the information available, recommend whether an impairment test is required for the following CGUs for the year ended 31 March 2023.
   a. Medical Equipment Unit
   b. Hotel Unit
   c. Automobile Unit

(b) Based on the information available, propose how the impairment loss of the Transport Unit should be allocated as at 31 March 2023.

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