Week 1

Australian Financial Reporting Environment

Not covered in class:

1. Explain the present accounting standard setting arrangements. (Who sets accounting standard?) (H&P LO 1.3)

   The Treasurer => The Financial Reporting Council (FRC) => The Australian Accounting Standards Board (AASB)

   The Financial Reporting Council (FRC):

   1. Appointment of the members of the AASB (except for the full-time Chair who is appointed by the Minister);

   2. Approving and monitoring the AASB's priorities, business plan, budget and staffing arrangement;

   3. Determining the AASB's broad strategic direction;

   4. Giving the AASB directions, advice or feedback on matters of general policy and the AASB's procedures;

   5. Monitoring the development of international accounting standards and furthering the harmonisation of Australian Accounting Standards with those standards, and promoting a greater role for international accounting standards in Australia.

   The Australian Accounting Standards Board (AASB):

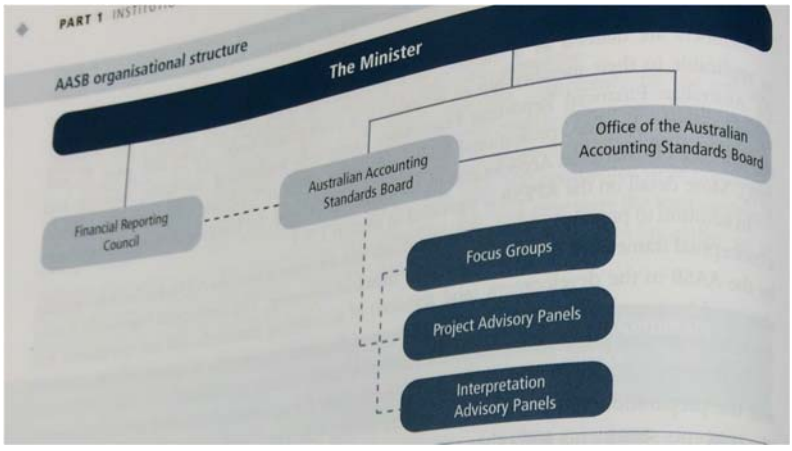
   1. to develop a conceptual framework, not having the force of an accounting standard, for the purpose of evaluating proposed accounting standards;

   2. to make accounting standards under section 334 of the Corporations Act 2001;

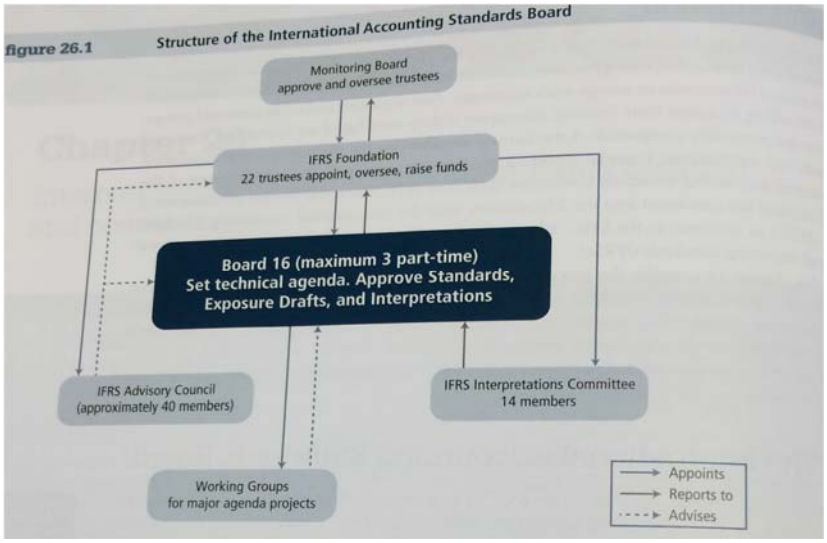
   3. to formulate accounting standards for other purposes;

   4. to participate in, and contribute to, the development of a single set of accounting standards for worldwide use;

   5. to advance and promote the main objectives of Part 12 of the Act as set down in section 224, which include reducing the cost of capital, enabling Australian entities to compete effectively overseas and maintaining investor confidence in the Australian economy.



2. Describe how the institutional arrangements for international accounting standard setting have evolved. (H&P LO 26.1)
   The globalization of capital markets
   →The International Accounting Standards Committee (IASC 1973)
   →The International Accounting Standards Board (IASB 2001)
   →International Financial Reporting Standards (IFRSs)
   The Australian Accounting Standards Board (AASB): reduce the diversity in accounting standards between countries.




3. Describe the development of international financial reporting standards. (H&P LO 26.2)
   IASB consults with the advisory committee & IFRS Advisory Council:
   A discussion paper for public comment
   → An exposure draft of the proposed accounting standard
   → A second exposure draft/ an International Financial Reporting Standard
   (approved by a supermajority vote: 10/16 of IASB members)
   Interpretations: approved when <4/14 of Interpretations Committee object;
   ratified by supermajority vote: 10/16 of IASB members.
   1. The IASB has worked to develop a 'partnership' with the national accounting standard setters.
   2. The IASB and FASB have been working toward convergence of IFRS and US generally accepted accounting principles (GAAP)

Covered in class:

1. Identify the main sources of regulation of financial reporting (H&P LO 1.1)
   A. Government Legislation: Corporations Act 2001
   B. ASX listing rules: only applies to entities whose securities are listed

C. Accounting standards: prepared by AASB; authority by the Corporations Act

2. Describe the convergence and harmonization policy adopted by the AASB (H&P LO 26.5)
   AASB revised its internationalization policy (2001):
   International convergence: Working with other standard-setting bodies to develop new or revised accounting standards
   International harmonization: Australian accounting standards being made compatible with the standards of international standard-setting bodies
   Financial Reporting Council (FRC) →AASB (Australian)
   1. Adopts IASB standards
   2. Change words to accommodate Australian legislation
   3. AAS25 remains in AASB
   4. RDR (reduced disclosure requirements) for small and medium entities. (IASB: FRS for small and medium entities)
   IASB (International): IFRS (International Financial Reporting Standards)

3. Explain the process of enforcing accounting standards and interpretations (H&P LO 1.5 & 1.6)
   A. Australian Securities and Investments Commission ("ASIC"):
   Administer and ensure compliance with the Corporations Act;
   Governing boards of companies must comply with AASB accounting standards;
   Financial reporting Panel (FRP): resolve disputes between ASIC and entities over the application of accounting standards. (2006-2012)
   B. Accounting bodies (ICAA, CPA & IPA) impose professional and ethical standards making it mandatory for members to comply with accounting standards. (APES 205).
   C. Governments

4. Define general purpose financial reporting and distinguish between general purpose financial statements and special purpose financial statements (H&P LO 2.4)
   General Purpose Financial Statements (GPFR): (AASB 101 para 7)
   Intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.
   Special Purpose Financial Statements are designed to suit information needs of specific financial statement users. e.g tax authorities

5. Identify the users of general purpose financial statements (H&P LO 2.5)

SAC 2 paras 16-20: Resource providers
Recipients of goods and services (customers)
Parties performing a review or oversight function.

6. Understand scope of financial reporting (H&P LO 2.6)
   As a guide, the FASB has concluded scope of GPFR include:
   Financial statements;
   Notes to financial statements;
   Supplementary information accompanying financial statements and notes;
   Supplementary information available on request;
   Voluntary information disclosed either in notes to the financial statements or as supplementary information.

7. Define the objective of general purpose financial reporting (H&P LO 2.8)
   GPFR: Provide information to users that is useful for making and evaluating decisions about the allocation of scarce resources.
   SAC 2 paras 21-25:
   - Resource providers want to know if entity is operating profitably and returning positive cash flows.
   - Recipients of goods and services may want to assess the ability of the reporting entity to continue to provide goods and services in the future.
   - Parties performing review or oversight services of interest to members of the community want to know whether the reporting entity has been operating in the interests of such members.

8. Understand the form and content of the performance statement (H&P LO 16.3)
   Form: AASB 101 (FP) para 81A requires the preparation of:
   - A single statement of comprehensive income; or
   - A separate income statement and a statement of comprehensive income
   Approach to profit measurement in AASB 101(FP) para 88:
   An entity shall recognize all items of income and expense in a period in profit or loss unless an Australian Accounting Standard requires or permits otherwise.
   Approach adopted in AASB 101 (FP):
   A comprehensive income approach: The Statement of Comprehensive Income includes items of other comprehensive income such as changes in asset revaluation surplus and actuarial gains and losses on defined benefit superannuation plans.

## Week 2
## Conceptual Framework Elements; Choice of Accounting Methods

Not covered in class:

1. Understand the basis for the recognition and measurement of equity (H&P LO 4.5)

Recognition (IASB 2010 Framework para 4.4(c)): the residual interest in the asset of the entity after deducting all its liabilities.

Measurement: the amount assigned to equity will always be the difference between the amounts of assets and liabilities, and the recognition criteria for assets and liabilities are also the criteria for the recognition of equity.

Covered in class:

Conceptual Framework Elements

1. Identify the recognition criteria for assets and understand the alternative measurement bases that may be employed (H&P LO 4.3)

Recognition (IASB 2010 Framework para 4.44): An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably. (Controlled by the entity as a result of past event)

Measurement (IASB 2010 Framework para 4.55): Generally, assets are measured at their cost of acquisition. (Historical cost)

Historical cost: A basis of measurement in which assets are measured at historical acquisition cost (less accumulated depreciation and accumulated impairment losses, if appropriate) and liabilities are measured at face or nominal amount.

Other proposed measurement bases are:

Current (replacement) cost: The amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired at the end of the reporting period.

Market (realisable) value (current cash equivalent): The amount of cash that could be obtained by selling the asset now in the ordinary course of business.

Present value (value in use): the discounted value of the future cash flows that it will generate.

Contingent assets (not recognised in the statement of financial position): A possible asset that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain events not wholly within the control of the entity.

- Have a cost or value that can be measured reliably BUT
- Arise in the future only as a result of the occurrence or non-occurrence of a particular event; and
- Should be disclosed in a note where an inflow of economic benefits is probable

2. Identify the recognition criteria for liabilities and understand the alternative

measurement bases that may be employed (H&P LO 4.4)

Recognition (IASB 2010 Framework para 4.46): A liability is recognised in the balance sheet 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.

Measurement (IASB 2010 Framework para 4.56): Liabilities should be measured in a way compatible with assets

Some examples of different approaches to measurement include:

- Historical cost
- Current (replacement) cost
- Market (realisable) value
- Fair value

The ultimate choice of the measurement basis for liabilities should be determined by reference to:

- The objective of general purpose financial reporting; and
- The qualitative characteristics of financial information

Contingent liability (not recognised in the statement of financial position): A possible obligation that arises from past events, the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

- An obligation that will arise in the future only as a result of the occurrence or non-occurrence of a particular event; and
- Should be disclosed in a note where the probability of a future sacrifice of economic benefits is higher than remote.

Choice of Accounting Methods

3. Understand that accounting standard setters and the preparers of financial statements have to make choices between alternative accounting policies (H&P LO 5.1)

Choices among alternative accounting policies are made at two times:

- Accounting standard setters - 'most appropriate' policy from alternatives when setting the standard
- Financial statement preparers - the 'most appropriate' policy from alternatives within the standard

4. Identify alternative approaches to the choice of accounting policies by accounting standard setters (H&P LO 5.2)

Historically the process has been very political and has required compromise.

The ad hoc period: largely political, determined by their acceptability to the business

community.

The conceptual framework period: issue and revise standards that were more consistent with each other and with an underlying theoretical basis.

The harmonisation period: IASC, ASX and "big business" (the group of 100): compliance with International Accounting Standards.

The convergence period: Financial Reporting Council (FRC) announced AASB converged with IASB.

5. Understand the reasons why choices of accounting policies are available to financial statement preparers and the attempts by Australian accounting standard setters to limit this choice (H&P LO 5.3)

The need to choose between accounting policies arises from three causes:

- 1. Aspects of financial reporting are not covered in accounting standards
- 2. Accounting standards may contain alternative policies
- 3. Required to make judgments or estimates. e.g. useful life and residual value

Management must choose accounting policies that result in relevant and reliable financial information

Limit: AASB108 paras 7, 10, 11, 12

AASB 108 para 7 when an Australian accounting standard applies to a transaction, that standard must be applied.

AASB 108 para 10 If there is not an applicable Australian accounting standard management uses judgement to ensure accounting policies chosen result in information that is relevant, faithful, neutral, prudent, complete and reflects the economic substance of transactions.

AASB 108 para 11 In applying judgement, management will look toward Australian accounting standards dealing with similar transactions and subsequently the definition and recognition criteria in the Framework.

AASB 108 para 12 Management may also consider recent pronouncements of other standard setting bodies that use a similar conceptual Framework.

In conclusion, preparers of financial statements have to choose accounting policies so information about the position and performance of the company can be provided to its financial statement users.

6. Explain 'creative accounting' by financial statement preparers (H&P LO 5.4)

"Creative" accounting is when accounting policies are made or chosen to ensure financial statements present the impression desired by financial statement preparers.

"Window dressing": it provides an opportunity to present unreliable financial statements

Four ways to be "creative" in preparing and presenting financial statements are:
- Choice of accounting policies
- Estimates or predictions of future events
- Disclosure of transactions or events
- Timing of transactions

› Note also emergence of new transactions and events calls for creative financial reporting solutions ("creative" is used here in a positive sense)

7. Identify the reasons why financial statement preparers choose particular accounting policies (H&P LO 5.5)

Some of the research into the reasons preparers make particular policy choices include:
- Income-smoothing motivations
- Capital market motivations: Share price
- Contractual motivations: management compensation contract and debt contract

› Much of this research deals with the idea of earnings management

8. Explain earnings management (H&P LO 5.6)

The income-smoothing hypothesis:
Managers choose policies to maximise own welfare:
- First, smooth reported profit
- Second, smooth the rate of growth in profit

Capital markets motivations:
Managers may manipulate profit to influence the share price:
- Avoiding losses
- Sustaining last year's performance
- Meeting analysts' forecasts

9. Understand the use of agency theory to explain and predict the choice of accounting policies by financial statement preparers (H&P LO 5.7)

Contractual motivations:
(Neoclassical economic theory: Individuals act in own self-interest)
A firm is a collection of self-interested individuals
Securing 'co-operation' requires:
- an explicit agreement (contract) OR an implicit understanding

› Contracting is costly: Agency costs

Agency relationships:
- One party (the principal) delegates decision-making authority to another (the

agent)
- Separation between ownership and control
'Agency' relationships exist between:
- Shareholders and managers
- Managers and debtholders

Role and significance of accounting
Accounting:
- Assists in contract design (ex ante); and
- Provides data for monitoring the terms of the contract (ex post)
› Accounting numbers influence:
- firm decisions and activities
- affect its cash flows and value
› Accounting policies are specified in contracts ex ante
› Agent still has some powers as accounting choices are made ex post
Contracting theory predicts: Agents will choose the form of accounting that best serves their self-interest

Political costs:
Regulation can be costly to business: higher taxes, higher reporting costs and efficiency losses
Large firms may adopt accounting policies that reduce accounting profit because of political costs:
- consumer hostility to large reported profits
- industrial action by employees

10. Multiple measures
A. Value (Higher): value in use (Present value of the future economic benefits)
value in exchange (Market/realisable value)
B. Historical cost
C. Current (replacement) cost
D. Market (realisable) value / current cash equivalent
E. Deprival value (value to the owner) (Lower):
1. Current (replacement) cost
2. (Higher): Present value (value in use)
Current cash equivalent (Market/replacement cost)

Week 3
Accounting for property, plant and equipment

1. Review the fundamental concepts covered in ACCT 5001

A. Definition of property, plant and equipment (PPE)

AASB 116, para 6:

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.

AASB 116, para 3:

This Standard does not apply to:

(a) property, plant and equipment classified as held for sale in accordance with AASB 5 Non-current Assets Held for Sale and Discontinued Operations;

(b) biological assets related to agricultural activity (see AASB 141 Agriculture);

(c) the recognition and measurement of exploration and evaluation assets (see AASB 6 Exploration for and Evaluation of Mineral Resources); or

(d) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

However, this Standard applies to property, plant and equipment used to develop or maintain the assets described in (b)-(d).

B. Initial recognition

AASB 116, paras 15 and 16：

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

Aus15.1 Notwithstanding paragraph 15, in respect of not-for-profit entities, where an asset is acquired at no cost, or for a nominal cost, the cost is its fair value as at the date of acquisition.

Aus15.2 In respect of not-for-profit entities, an item of property, plant and equipment may be gifted or contributed to the entity. For example, land may be contributed to a local government by a developer at no or nominal consideration to enable the local government to develop parks, roads and paths in the development. An asset may also be acquired for no or nominal consideration through the exercise of powers of sequestration. Under these circumstances the cost of the item is its fair value as at the date it is acquired.

Aus15.3 In respect of not-for-profit entities, for the purposes of this Standard, the initial recognition at fair value of an item of property, plant and equipment, acquired at no or nominal cost, consistent with the requirements of paragraph Aus15.1, does not constitute a revaluation. Accordingly, the revaluation requirements in paragraph 31, and the supporting commentary in paragraphs 32 to 35, only apply where an entity elects to revalue an item of property, plant and equipment in subsequent reporting periods.

16 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; and

(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.

C. Depreciation

50 The depreciable amount of an asset shall be allocated on a systematic basis over its useful life. (AASB 116， para 50)

> Note: Land=> not depreciate

What decisions do preparers have to make here?

51 The residual value and the useful life of an asset shall be reviewed at least at the end of each annual reporting period and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors. (AASB 116， para 51)

Depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity (AASB 116, para 60)

Depreciable amount is the cost of an asset less its residual value (AASB 116, para 6)

D. Derecognition

› On disposal, an asset must be removed from the statement of financial position (AASB 116, para 67)

› Gain or loss on disposal:

- Difference between carrying amount at the date of disposal and the net disposal proceeds (para 71)

- Gain or loss on disposal goes to statement of income – but not to be shown as revenue (para 68)

2. Understand the requirements in AASB 116 for the measurement of PPE (H&P LO 8.2 & 8.5)

Subsequent to initial recognition:

Items of PPE must be measured using either the cost model or the revaluation model (AASB 116, para 29)

- Cost model: cost less accumulated depreciation and impairment losses (AASB 116, para

30)
- Revaluation model: fair value at date of revaluation less any subsequent depreciation and impairment losses (AASB 116, para 31)

Once the choice is made:
- All assets in the same class (being assets of a similar nature and function) must be measured on the same basis (AASB 116, para 36)
- A change in policy is only allowed if information is reliable and more relevant (AASB 108, para 14)
>NB: AASB 140 Investment Properties (para 31) states "it is highly unlikely …a change from the fair value model to the cost model will result in more relevant information."
Both cost and revaluation models are acceptable, so what factors influence the choice?
- Relevance to users v. verifiability
- Costs associated with revaluations
- Effect on income (and management bonus plans): depreciation and gain on sale
- Impact on debt/equity ratio
- Public perception

Fair value is the price that would be received to sell an asset ….in an orderly transaction between market participants at the measurement date (AASB 116, para 6)
AASB 13 provides further guidance–characteristics (paras 11-14); nature of transaction (paras 15-21); market participants (paras 22-23), pricing; and, if applicable, non-financial asset issues (paras 24-33)
AASB 116 requires that:
- Revaluations are sufficient frequent that the carrying amount does not differ materially from fair value at reporting date (AASB 116, para 31)
- For some classes of PPE, revaluations may be needed each year. For other classes of PPE revaluations may only be needed every 3 to 5 years. (AASB 116, para 34).

Two ways to treat accumulated depreciation when an asset is revalued:
› Net method: Preferred ACCT 6001 method
Accumulated depreciation of the asset to be revalued is closed to the asset account before revaluation
› Gross method:
The balance of accumulated depreciation at the date of revaluation is increased by the same proportion as the gross carrying amount of the asset

e.g. building: $ 3,000,000 (6 years)
After a year, revaluation: $ 3,250,000

| | | | |
|---|---|---|---|
| Acquisition: Building | 3,000,000 | | |
| Cash, payables etc | | 3,000,000 | |
| Depreciation: Depreciation expense | 500,000 | | |
| Accumulated depreciation | | 500,000 | |
| Close accumulated depreciation: | | | |
| Accumulated depreciation | 500,000 | | |
| Building | | 500,000 | |
| (Carrying amount: 2,500,000) | | | |
| Revaluation of building $ 3,250,000: | | | |
| Building | 750,000 | | |
| Revaluation | | 750,000 | |
| The statement of financial position: | | | |
| Building | 3,250,000 | | |
| Less Accumulated depreciation | --- | | |
| | 3,250,000 | | |
| Depreciation: Depreciation expense | 650,000 | | |
| Accumulated depreciation | | 650,000 | (3,250,000/5) |

Increases in the carrying amount of an asset: (AASB 116, para 39)
- Recognised in other comprehensive income (OCI) and then accumulated in equity as a 'revaluation surplus'
- However, to the extent that it reverses a previous revaluation decrement of the same asset that was previously recognised in profit or loss, it will be recognised in profit or loss

Decreases in the carrying amount of an asset: (AASB 116, para 40)
- Recognised in profit or loss as a "revaluation expense"
- However, to the extent of any credit balance in revaluation surplus relating to that asset, the decrement shall be debited to the revaluation surplus (via OCI)

e.g. Asset A is written down by $ 100,000, Asset B is written up by $150,000.

| | | |
|---|---|---|
| Revaluation expense | 100,000 | |
| Asset A | | 100,000 |
| Asset B | 150,000 | |
| Revaluation surplus | | 150,000 |

Scenario 1. Asset A increased by $ 50,000, Asset B decreased by $ 100,000.

| | | |
|---|---|---|
| Asset A | 50,000 | |
| Revaluation income | | 50,000 |
| Revaluation surplus | 100,000 | |
| Asset B | | 100,000 |

Scenario 2. Asset A increased by $150,000, Asset B decreased by $200,000.

| | | |
|---|---|---|
| Asset A | 150,000 | |
| Revaluation income | | 100,000 |
| Revaluation surplus | | 50,000 |
| Revaluation surplus | 150,000 | |
| Revaluation expense | 50,000 | |
| Asset B | | 200,000 |

After revaluation, the carrying amount of an asset will be: fair value (or, if an old FV is used, then FV at date of revaluation less any subsequent accumulated depreciation and impairment) (AASB116, para 31)

Derecognition of PPE

› On disposal, an asset must be removed from the statement of financial position (AASB 116, para 67)

› Gain or loss on disposal:

- Difference between carrying amount at the date of disposal and the net disposal proceeds (para 71)

- Gain or loss on disposal goes to statement of income – but not to be shown as revenue (para 68)

Revaluation surplus (Equity)

AASB 116 para 41 allows two options:

1. Revaluation surplus transferred to retained earnings (Preferred ACCT6001 method) OR
2. Some surplus transferred to retained earnings as asset is used

e.g. Cost model

| | | |
|---|---|---|
| Property, plant and equipment | $ 1,000,000 | |
| Less Accumulated depreciation | 600,000 | |
| | $ 400,000 | |
| Sold for $450,000: | | |
| Cash at bank | 450,000 | |
| Accumulated depreciation | 600,000 | |
| Property, plant and equipment | | 1,000,000 |
| Gain on sale | | 50,000 |

Revaluation model

| | | |
|---|---|---|
| Revaluation to $500,000: | | |
| Accumulated depreciation | 600,000 | |
| Property, plant and equipment | | 600,000 |

| | | |
|---|---|---|
| (Carrying amount: $400,000) | | |
| Property, plant and equipment | 100,000 | |
| Revaluation surplus | | 100,000 |
| Sold for $450,000: | | |
| Cash at bank | 450,000 | |
| Loss on sale | 50,000 | |
| Property, plant and equipment | | 500,000 |
| Revaluation surplus | 100,000 | |
| Retained earnings | | 100,000 |

3. Understand the impairment test in AASB 136 (H&P LO 8.6 & 8.7)

AASB 136 requires that: An asset is carried at no more than its recoverable amount.

AASB 136 para 6: The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use.

AASB 136 para 9: 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.

AASB 136 para 59: If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss.

AASB 136 para 60: An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (e.g. in accordance with the revaluation model in AASB 116). Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.

If RA < 'carrying amount', reduce the asset to its RA (AASB 136, para 59)

Lower: Carrying amount

Recoverable amount (Higher): Fair value-costs of disposal

Value in use

Indicators of impairment (AASB 136, para 12)

External factors include:

- Decline in market value more than normal wear and tear
- Increase in interest rates that reduces RA (i.e. reduces discounted cash flows)

Internal factors include:

- Obsolescence or physical damage to an asset
- Changes, such as restructuring, that could affect the value in use of an asset

Impairment loss (AASB 136, para 60)

An impairment loss shall be recognised:

- Immediately in profit or loss unless the asset is carried at revalued amount in accordance with another Standard

Any impairment loss of a revalued asset shall be:

- Treated as a revaluation decrease in accordance with the other Standard

e.g. Cost model

Equipment's carrying amount is $760,000, value in use is $700,000, and current market value of the asset less costs to sell is $750,000.

Recoverable amount: $750,000, there is an impairment loss of $10,000:

| | | |
|---|---|---|
| Impairment loss | $ 10,000 | |
| Accumulated impairment losses | | $ 10,000 |

Revaluation model

Carrying amount = fair value = $ 800,000, revalued upwards of $40,000 to the revaluation surplus.

Recoverable amount: $750,000, there is an impairment loss of $ 50,000:

| | | |
|---|---|---|
| Revaluation surplus | $ 40,000 | |
| Impairment loss | $ 10,000 | |
| Accumulated impairment losses | | $ 50,000 |

Reversal of impairment

At the end of each reporting period: (AASB 136, paras 110 & 124)

- An assessment should be made of whether there is any indication that a prior impairment no longer exists or has decreased for any asset other than goodwill

Indicators of reversal of prior impairment: AASB 136 (para 111)

External sources of information

(a) The asset's market value has increased significantly during the period;

(b) significant changes with a favourable effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which the asset is dedicated;

(c) market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially;

Internal sources of information

(d) significant changes with a favourable effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used. These changes include costs incurred during the period to improve or enhance the asset's performance or restructure the operation to which the asset belongs; and

(e) Evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected.

›If RA now > CA

AASB 116, para 117: The asset's carrying amount is increased to its recoverable amount but cannot exceed the carrying amount that would have been calculated had the impairment loss not occurred in prior years (Ceiling)

AASB 116, para 119: An income item 'reversal of impairment loss' is recognised unless the asset is carried at a revalued amount, in which case the reversal shall be treated as a revaluation increment

e.g. Cost model

01/07/2012 the acquisition of asset:

| | | |
|---|---|---|
| Asset | $ 1,000,000 | |
| Cash at bank | | $ 1,000,000 |

30/06/2013 Depreciation (1,000,000/5=200,000):

| | | |
|---|---|---|
| Depreciation expense | $200,000 | |
| Accumulated depreciation | | $200,000 |

Carrying amount: $800,000, recoverable amount: $700,000, an impairment loss of $100,000:

| | | |
|---|---|---|
| Impairment loss | $100,000 | |
| Accumulated impairment losses | | $100,000 |

30/06/2014 Depreciation (700,000/4=175,000):

| | | |
|---|---|---|
| Depreciation expense | $175,000 | |
| Accumulated depreciation | | $175,000 |

Carrying amount: $525,000, recoverable amount: $575,000, a potential reversal of impairment: $50,000.

| Date | Cost | Accumulated depreciation | Ceiling |
|---|---|---|---|
| 30/06/2013 | $ 1,000,000 | $ 200,000 | $ 800,000 |
| 30/06/2014 | $ 1,000,000 | $ 400,000 | $ 600,000 |
| 30/06/2015 | $ 1,000,000 | $ 600,000 | $ 400,000 |
| 30/06/2016 | $ 1,000,000 | $ 800,000 | $ 200,000 |
| 30/06/2017 | $ 1,000,000 | $ 1,000,000 | nil |

Ceiling for carrying amount is $600,000.

| | | |
|---|---|---|
| Accumulated impairment losses | $ 50,000 | |
| Reversal of impairment loss | | $ 50,000 |

30/06/2015 Carrying amount is $ 575,000, Depreciation (575,000/3=191,667):

| | | |
|---|---|---|
| Depreciation expense | $191,667 | |

| | | |
|---|---|---|
| Accumulated depreciation | | $191,667 |

Carrying amount is $383,333, recoverable amount is $450,000, ceiling for carrying amount is $400,000, the reversal of the impairment loss will be 400,000-383,333=16,667:

| | | |
|---|---|---|
| Accumulated impairment losses | $ 16,667 | |
| Reversal of impairment loss | | $ 16,667 |

30/06/2016 Depreciation (400,000/2=200,000):

| | | |
|---|---|---|
| Depreciation expense | $200,000 | |
| Accumulated depreciation | | $200,000 |

Carrying amount is $200,000, sold for $300,000:

| | | |
|---|---|---|
| Cash at bank | $300,000 | |
| Accumulated depreciation | $766,667 | |
| Accumulated impairment losses | $ 33,333 | |
| Asset | | $1,000,000 |
| Gain on sale | | $100,000 |

Revaluation model (non-depreciable property):

01/07/2011 the acquisition of asset:

| | | |
|---|---|---|
| Asset | $ 600,000 | |
| Cash at bank | | $ 600,000 |

30/06/2012 Fair value is $660,000:

| | | |
|---|---|---|
| Asset | $60,000 | |
| Revaluation surplus | | $60,000 |

30/06/2013 Fair value=Carrying amount= $660,000, recoverable amount is $630,000, an impairment loss of $30,000.

| | | |
|---|---|---|
| Revaluation surplus | $30,000 | |
| Accumulated impairment losses | | $30,000 |

30/06/2014 Fair value=Carrying amount= $630,000, recoverable amount is $650,000, a potential reversal of impairment of $20,000. The ceiling of carrying amount is $630,000 (fair value without impairment).

No journal entries.

Hint: The order of applying the revaluation model and impairment loss previsions is important. Students need to be refer to AASB 136(FP) para 5. The revaluation requirements of AASB 116 need to be applied first before an impairment loss can be recognised under AASB 136(FP).

The order of reversing impairment losses and previous years' revaluation adjustments is not important as any reversal of an impairment loss for a revalued asset must be treated as a revaluation increase as per AASB 116. Accordingly reversals of impairment losses for

assets under the revaluation model could include reversal of previous year's impairment losses together with reversal of previous year's revaluation expenses. Students should refer to AASB 136(FP) para 119

WEEK 4

Accounting for Intangible Assets

1. Understand the nature of intangible assets (H&P LO 11.1)

An intangible asset is: An identifiable non-monetary asset without physical substance. (AASB 138, para.8)

Due to nature of intangible assets, three factors are necessary for the existence of an intangible asset that falls under AASB 138:

-Identifiability (AASB 138, paras 11-13)

-Control (AASB 138, paras 13-16)

-Existence of future economic benefits (AASB 138, para 17)

2. Distinguish intangible assets from goodwill (H&P LO 11.2)

Intangible assets: are identifiable

-include patents, copyrights, research and development, trademarks, brand names, newspaper mastheads, television and radio licences and franchises

Goodwill represents: Future economic benefits from assets that are not capable of being individually identified and separately recognised. It is covered in AASB 3

(Also a kind of intangible asset, but not identifiable)

3. Distinguish between purchased and internally-generated intangible assets (H&P LO 11.3)

For purchased intangible assets (in an arm's-length transaction):

Recognition is required in circumstances similar to those for other assets (AASB 138, paras 25-32)

There are two ways of purchasing intangible assets:

- separately; or
- as part of a business combination.

For internally-generated intangible assets:

- Distinguish between a research phase and a development phase
- Recognition is limited (AASB 138, paras 51-64):

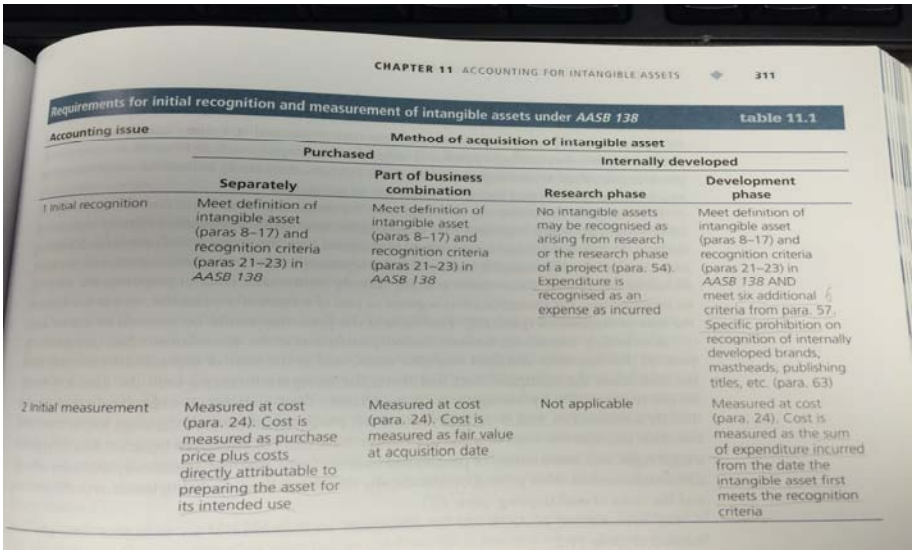
If it is expected to yield future economic benefits and satisfies 6 conditions:

- It should also be recorded as an asset at its cost of development

e.g. an internally-generated computer system.

Recognition of an internally-generated intangible asset:

If future economic benefits are acquired, an asset should be recognised provided:
- it is probable(>50%) that those benefits will be received; and
- the asset's cost or other value can be measured reliably
(AASB 138, para 21)



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Requirements for initial recognition and measurement of intangible assets under *AASB 138* — table 11.1

| Accounting issue | Method of acquisition of intangible asset | | | |
|---|---|---|---|---|
| | Purchased | | Internally developed | |
| | Separately | Part of business combination | Research phase | Development phase |
| 1 Initial recognition | Meet definition of intangible asset (paras 8–17) and recognition criteria (paras 21–23) in *AASB 138* | Meet definition of intangible asset (paras 8–17) and recognition criteria (paras 21–23) in *AASB 138* | No intangible assets may be recognised as arising from research or the research phase of a project (para. 54). Expenditure is recognised as an expense as incurred | Meet definition of intangible asset (paras 8–17) and recognition criteria (paras 21–23) in *AASB 138* AND meet six additional criteria from para. 57. Specific prohibition on recognition of internally developed brands, mastheads, publishing titles, etc. (para. 63) |
| 2 Initial measurement | Measured at cost (para. 24). Cost is measured as purchase price plus costs directly attributable to preparing the asset for its intended use | Measured at cost (para. 24). Cost is measured as fair value at acquisition date | Not applicable | Measured at cost (para. 24). Cost is measured as the sum of expenditure incurred from the date the intangible asset first meets the recognition criteria |

Research: far away from benefits => expenses
Development: probably bring future benefits =>
6 criteria (AASB 138, para 7) => Capitalisation

4. Apply AASB 138 'Intangible Assets' to initial and subsequent measurement of intangible assets (H&P LO 11.4)
Initial measurement at cost (AASB 138, para 24):
An intangible asset shall be measured initially at cost.
Notwithstanding paragraph 24, in respect of not-for-profit entities, where an asset is acquired at no cost, or for a nominal cost, the cost is its fair value as at the date of acquisition.
Subsequent measurement:
AASB 138 (para 72) permits two bases for measuring intangible assets after initial recognition:
-cost model (AASB 138, para 74)
-revaluation model; but active market must exist (AASB 138, para 75)

Specific intangible assets:
>Trademarks and brand names:
(They are used to differentiate products in the eyes of consumers)
-If purchased, they should be recognised as assets in accordance with AASB 138, para 72; and measured initially at cost; subsequent measurement remains on the cost basis, as they

do not have active markets (AASB 138, para 78)
-Internally-generated brand names cannot be recognised as intangible assets (AASB 138, para 63)
>Computer software and website costs:
-If purchased, they should be recognised as an asset and recorded (initially and subsequently) at cost (AASB 138, para 72)
-If internally-generated, the rules for research and development apply

5. Distinguish between research and development, and explain potential alternative methods of accounting (H&P LO 11.5 & 11.6)
Research is defined as (AASB 138, para 8):
-Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding
-The pursuit of knowledge, without any defined commercial objective

(AASB 138, para 56 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; and
(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.)

Development is defined as (AASB 138, para 8):
-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.

(AASB 138, para 59 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.)

Selective capitalisation method (International & Australian):
Some R&D costs are recognised as intangible assets while others are recognised as expenses

6. Apply AASB 138 to internally-generated R&D (H&P LO 11.7)

AASB 138 adopts a selective capitalisation approach:
- Research is an expense (AASB 138, para 54)
- Development costs meeting six conditions must be capitalised (AASB 138, para 57)

> 57 An intangible asset arising from development (or from the development phase of an internal project) shall be recognised 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; and
> (f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Initial measurement of development:
If recognised, initially measured at cost (see AASB 138, paras 66-67)
Cost is the sum of the expenditure incurred from the date when the intangible asset first meets all the recognition requirements (AASB 138, para 65)
Subsequent measurement of development:
As development assets do not have an active market, only the cost model can be used (AASB 138, para 74)

7. Understand and apply AASB 138 on amortisation and impairment (H&P LO 11.4)
AASB 138 - Amortisation or impairment:
>If the asset has a finite life, there should be amortisation of depreciable amount on a systematic basis over useful life (AASB 138, para 97)
For intangible assets, residual value is usually assumed to be zero (AASB 138, para 100)
>Intangible assets with indefinite useful lives are not amortised but must be tested for impairment each year (AASB 138, paras 107-108)
Trademarks and brand names:
Some are amortised (finite life); some are not amortised (indefinite life).

Impairment of intangible assets:
As well as those intangibles with indefinite lives being tested annually for impairment (AASB 136, para 10(a)), all intangible assets are subject to the normal impairment testing

(AASB 136, para 59)
As for PPE, recoverable amount is the higher of (i) fair value less costs of disposal or (ii) value in use (AASB 136, para 6)
As usual, fair value is the price that would be received to sell an asset ....in an orderly transaction between market participants at the measurement date (AASB 136, para6)

Amortisation: example of development:
›Development assets presumably have a finite life, so must be amortised on a systematic basis (AASB 138, para 97)
In most cases, residual value is assumed to be zero (AASB 138, para 100)
Development assets are subject to AASB 138 rules on impairment (para 111)

e.g. 01/07/2012 Plastic Recyclers Ltd was established with an initial capital of $4 million. It acquired a licence for $1 million (5 years).

| | | |
|---|---|---|
| Cash at bank | $4,000,000 | |
| Share capital | | $4,000,000 |
| Licence | $1,000,000 | |
| Cash at bank | | $1,000,000 |

11/2012 It set up a plastics receiving depot and processing plant. Setting up a plastics collection network for $250,000.

| | | |
|---|---|---|
| Property, plant and equipment | $2,000,000 | |
| Cash at bank | | $2,000,000 |
| Development expense | $ 250,000 | |
| Cash at bank | | $ 250,000 |

04/2013 Testing its operational capability and resolving problems for $600,000.

| | | |
|---|---|---|
| Development expense | $ 600,000 | |
| Cash at bank | | $ 600,000 |

From 01/06/2013, all the conditions necessary for capitalisation of development costs are satisfied.
30/06/2013

| | | |
|---|---|---|
| Amortisation of licence | $ 200,000 | |
| Accumulated amortisation | | $ 200,000 |
| Research and development | $16,667 | |
| Amortisation of licence | | $16,667 |
| (200,000/12=16,667) | | |

Income Statement

| | |
|---|---|
| **Expenses** | |
| Development expenses | $ 850,000 |
| Amortisation of licence | 183333 |

| | | |
|---|---|---|
| Loss | | $1,033,000 |

Balance Sheet

| | | |
|---|---|---|
| **Current Assets** | | |
| Cash at bank | | $150,000 |
| **Non-current Assets** | | |
| Property, plant and equipment | | 2000,000 |
| Licence | $1,000,000 | |
| Less Accumulated amortisation | 200,000 | 800,000 |
| Research and development | | 16,667 |
| | | $2966, 667 |
| **Equity** | | |
| Share capital | | $4000, 000 |
| Retained earnings | | (1,033, 333) |
| | | $2,966, 667 |

Impairment losses

Any impairment loss is recognised in profit or loss, unless the asset is measured with the revaluation model, which is rare (AASB 136, para 60)

e.g. 01/10/2012 A large Australian wine company acquired Benfolds' wine brand names for a fair value of $ 5 million (20 years).

| | | |
|---|---|---|
| Brand names | $ 5,000,000 | |
| Cash/Share capital | | $ 5,000,000 |

30/09/2013

| | | |
|---|---|---|
| Amortisation of brand names | $ 250,000 | |
| Accumulated amortisation---brand names | | $ 250,000 |

30/09/2014

| | | |
|---|---|---|
| Amortisation of brand names | $ 250,000 | |
| Accumulated amortisation---brand names | | $ 250,000 |

Carrying amount: 5,000,000-5,000,000=4,500,000; recoverable amount: 3 million;
An impairment loss of 1,500,000.

| | | |
|---|---|---|
| Impairment loss---brand names | $1,500,000 | |
| Accumulated amortisation---brand names | | $1,500,000 |

Statement of financial position:

| | |
|---|---|
| Brand names | $ 5,000,000 |
| Accumulated amortisation | 500,000 |
| Accumulated impairment loss | 1,500,000 |
| | $ 3,000,000 |

AASB 138 – Disclosures:
AASB 138 (para 126) requires disclosure of the aggregate amount of R&D recognised as an expense
Other general disclosures required (AASB 138, para 118) such as:
-Whether useful lives are indefinite or finite and, if finite, the useful lives or amortisation rates used
-Amortisation methods used for intangible assets with finite lives
-Reconcile the opening and closing asset balances

Week 5
Accounting for Leases
1. Understand the nature of leases (H&P LO 12.1)
What is a lease?
A lease is an agreement conveying the right to use a piece of property for a stated period of time, in return for a series of payments.
Parties to the lease:
Lessor - the owner of property that conveys the right to use the property for a specified period of time in return for a series of payments
Lessee - party entering into a lease agreement with a lessor
Typical terms in lease agreements:
- Period of the lease
- Amount and timing of the lease payments
- Whether the lease is cancellable by either party
- What is to become of the asset at the end of the lease term
- The asset's residual value
- Responsibility for payment of maintenance etc costs

2. Distinguish between an operating lease and a finance lease (H&P LO 12.2)
AASB 117 focuses on the asset aspect of the lease agreement, and identifies two key types of leases based on the typical features in the lease agreement: finance lease or operating lease
›Operating lease (AASB 117 para 8):
The risks and rewards of ownership remain substantially with the lessor
› Finance lease (AASB 117 para 8):
The risks and rewards of ownership are transferred substantially to the lessee
Risks include:
The possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions (AASB 117 para 7).

Rewards may be represented by:
The expectation of profitable operation over the asset's life and gain from appreciation in value (AASB 117 para 7)
Classification of a lease depends on substance of the transaction rather than the form of the contract (AASB 117 para 10)

3. Understand the difference between the 'expense' and 'capitalisation' methods of accounting for finance leases in the books of a lessee (H&P LO 12.3)
Rental (or expense) method:
A method of accounting for leases under which the lessee recognises assets and liabilities only from accruals or prepayments of lease rentals.
Finance method:
A method of accounting for finance leases by the lessee in which the asset is measured as the present value of the rental payments and is known as 'leased asset'.
Background: concern about the level of company borrowings not reported on the company's statement of financial position (known as off-balance sheet financing)

e.g. Initial recognition

An agreement to lease machinery for 5 years at an annual rental of $1,000 payable at the end of each year. No residual value. It could be purchased for $3.605. If there is no purchase price, the lessor earns 12% per annum.

$$PV = A\frac{1-(1+i)^{-n}}{i}$$

$$PV = 1000\frac{1-(1+12\%)^{-5}}{12\%} = \$3605$$

| | | |
|---|---|---|
| Machinery under lease | $ 3,605 | |
| Lease liability | | $ 3,605 |

Subsequent measurement
Principle: $3605, Interest rate: 12%, Annual payment: $1000.
1st year: Interest: 3605*12%=433; Principal repayment: 1000-433=567.

| | | |
|---|---|---|
| Interest expense | $433 | |
| Lease liability | $567 | |
| Cash at bank | | $1,000 |

2nd year: Liability: 3605-567=3038;
Interest: 3038*12%=365; Principal repayment: 1000-365=635.

| | | |
|---|---|---|
| Interest expense | $365 | |
| Lease liability | $635 | |
| Cash at bank | | $1,000 |

| End of year | Rental payment ($) | Interest expense ($) | Reduction in lease liability ($) | Lease liability ($) |
|---|---|---|---|---|
| 0 | – | – | – | 3 605 |
| 1 | 1 000 | 433 | 567 | 3 038 |
| 2 | 1 000 | 365 | 635 | 2 403 |
| 3 | 1 000 | 288 | 712 | 1 691 |
| 4 | 1 000 | 203 | 797 | 894 |
| 5 | 1 000 | 106 | 894 | – |
| | $5 000 | $1 395 | $3 605 | |

Depreciation:

5 years, a straight-line basis, the annual depreciation will be 3605/5=721.

| End of year | Cost ($) | Accumulated depreciation ($) | Carrying amount ($) |
|---|---|---|---|
| 0 | 3 605 | – | 3 605 |
| 1 | 3 605 | 721 | 2 884 |
| 2 | 3 605 | 1 442 | 2 163 |
| 3 | 3 605 | 2 163 | 1 442 |
| 4 | 3 605 | 2 884 | 721 |
| 5 | 3 605 | 3 605 | – |

The expenses associated with the lease:

| Year | Interest expense ($) | Depreciation expense ($) | Total ($) |
|---|---|---|---|
| 1 | 433 | 721 | 1 154 |
| 2 | 365 | 721 | 1 086 |
| 3 | 288 | 721 | 1 009 |
| 4 | 203 | 721 | 924 |
| 5 | 106 | 721 | 827 |
| | $1 395 | $3 605 | $5 000 |

4. Understand the implications of lease accounting for assessment of operating performance and financial risk (H&P LO 12.5)

Operating leases (off-balance sheet):

-No lease assets or liabilities are recognised

-All lease payments are recognised as expenses when incurred.

Finance leases (on-balance sheet):

-Leased asset & lease liability recognised at inception

-Lease payments split between interest & principle

-Leased asset subject to depreciation/amortisation

Financial reporting implications of classifying leases as finance leases:

-Generally entity's debt ratio is increased

Noncurrent asset↑ Interest + a part of principle=current liability↑ Noncurrent liability↑ => current ratio (CA/CL)↑
-Performance measures will most likely be reduced (eg return on total assets)
›Managers have incentives to favour operating leases

5. Apply the requirements of AASB 117 to the classification of leases (H&P LO 12.6)
Indicators of a finance lease (AASB 117 paras .10 & .11):
10 Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:
(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
(b) the lessee has the option to purchase the asset at a bargain price;
(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.
11 Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:
(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.
›Minimum lease payments (MLP): rental payments over the lease & includes (AASB 117 para 4):
bargain purchase option – a clause in the lease agreement that allows the lessee to purchase the leased asset at the end of the lease term for an amount significantly less than its residual value at the end of the lease term
guaranteed residual value – (a) for a lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and
(b) for a lessor, that part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.
but does not include:

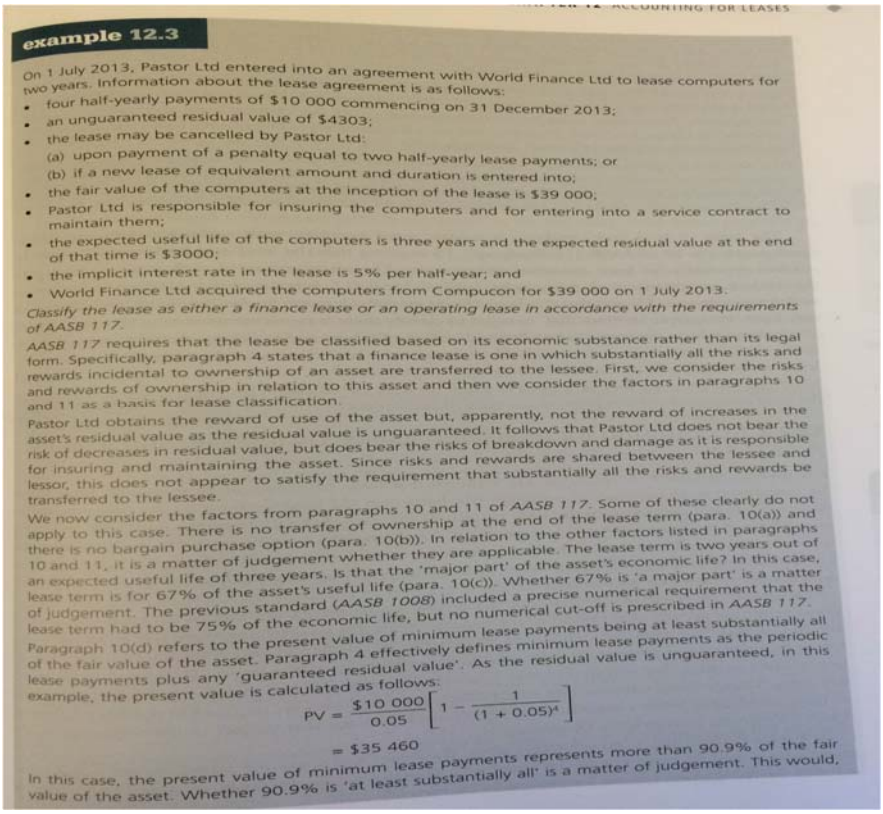
– executory costs (insurance, repairs etc.)
– contingent rentals
– unguaranteed residual value

MLP= rental payments+ bargain purchase option+ guaranteed residual value
It is used as one of the factors to determine whether a lease is classified as a finance or operating lease
It may be the amount initially capitalised (at PV) as the finance lease asset & liability in the lessee's financial statements
e.g. Snow Ltd (lessee) agreed to lease an item of machinery from Rain Ltd (lessor):
• Date of commencement of the lease 1/7/2014
• Duration of lease 8 years
• Fair value at lease inception $478,490
• Initial up-front payment $60,000
• Lease payments at end of the year $70,000
• Implicit rate of interest 8%
• Economic life of asset 10 years
• During lease term, lessee must maintain & insure
• Machinery returned to lessor at end of the lease
• Expected unguaranteed residual value of $30,000
(no reward of increases in residual value, no risks of decreases in residual value=> rewards & risks shared between lessee and lessor)
• Lease cancellable on payment of penalty of 3 lease payments ($210,000)
Is this a finance or operating lease?
Which party has the risks & rewards of ownership:
Does ownership of the property transfer to the lessee? (Operating lease)
Is the lease term for most of the economic life of the asset? (Finance lease)
Is the lease cancellable? (Lessee's option=>Finance lease)
Is the PV of minimum lease payments equal to substantially all of the FV of the asset?

$$PV = 70{,}000\frac{1-(1+8\%)^{-8}}{8\%} = 70{,}000 * 5.747 = 402{,}290$$

$$\frac{MLP}{Fair\ Value} = \frac{402{,}290+60{,}000}{478{,}490} = 97\% \Rightarrow \text{Finance lease}$$

In conclusion, the risks & reward was transferred.



**example 12.3**

On 1 July 2013, Pastor Ltd entered into an agreement with World Finance Ltd to lease computers for two years. Information about the lease agreement is as follows:

- four half-yearly payments of $10 000 commencing on 31 December 2013;
- an unguaranteed residual value of $4303;
- the lease may be cancelled by Pastor Ltd:
  (a) upon payment of a penalty equal to two half-yearly lease payments; or
  (b) if a new lease of equivalent amount and duration is entered into;
- the fair value of the computers at the inception of the lease is $39 000;
- Pastor Ltd is responsible for insuring the computers and for entering into a service contract to maintain them;
- the expected useful life of the computers is three years and the expected residual value at the end of that time is $3000;
- the implicit interest rate in the lease is 5% per half-year; and
- World Finance Ltd acquired the computers from Compucon for $39 000 on 1 July 2013.

*Classify the lease as either a finance lease or an operating lease in accordance with the requirements of AASB 117.*

*AASB 117* requires that the lease be classified based on its economic substance rather than its legal form. Specifically, paragraph 4 states that a finance lease is one in which substantially all the risks and rewards incidental to ownership of an asset are transferred to the lessee. First, we consider the risks and rewards of ownership in relation to this asset and then we consider the factors in paragraphs 10 and 11 as a basis for lease classification.

Pastor Ltd obtains the reward of use of the asset but, apparently, not the reward of increases in the asset's residual value as the residual value is unguaranteed. It follows that Pastor Ltd does not bear the risk of decreases in residual value, but does bear the risks of breakdown and damage as it is responsible for insuring and maintaining the asset. Since risks and rewards are shared between the lessee and lessor, this does not appear to satisfy the requirement that substantially all the risks and rewards be transferred to the lessee.

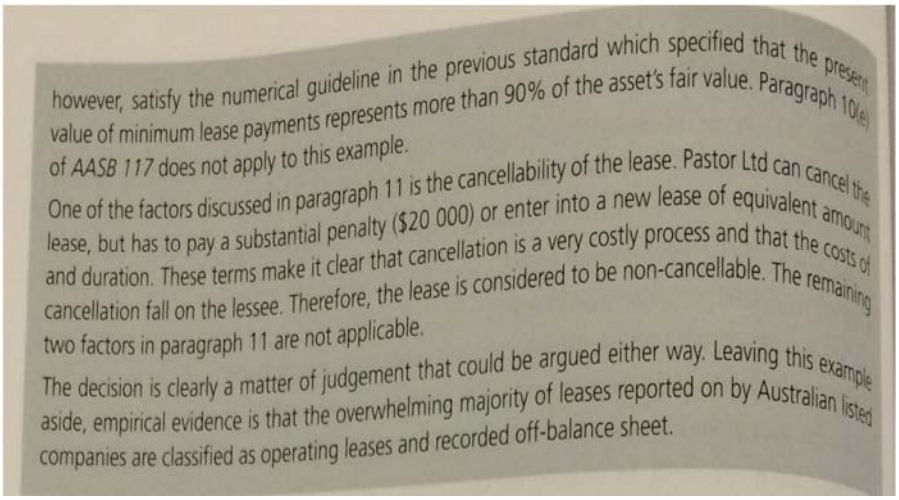
We now consider the factors from paragraphs 10 and 11 of *AASB 117*. Some of these clearly do not apply to this case. There is no transfer of ownership at the end of the lease term (para. 10(a)) and there is no bargain purchase option (para. 10(b)). In relation to the other factors listed in paragraphs 10 and 11, it is a matter of judgement whether they are applicable. The lease term is two years out of an expected useful life of three years. Is that the 'major part' of the asset's economic life? In this case, lease term is for 67% of the asset's useful life (para. 10(c)). Whether 67% is 'a major part' is a matter of judgement. The previous standard (*AASB 1008*) included a precise numerical requirement that the lease term had to be 75% of the economic life, but no numerical cut-off is prescribed in *AASB 117*.

Paragraph 10(d) refers to the present value of minimum lease payments being at least substantially all of the fair value of the asset. Paragraph 4 effectively defines minimum lease payments as the periodic lease payments plus any 'guaranteed residual value'. As the residual value is unguaranteed, in this example, the present value is calculated as follows:

$$PV = \frac{\$10\,000}{0.05}\left[1 - \frac{1}{(1 + 0.05)^4}\right]$$

$$= \$35\,460$$

In this case, the present value of minimum lease payments represents more than 90.9% of the fair value of the asset. Whether 90.9% is 'at least substantially all' is a matter of judgement. This would,



however, satisfy the numerical guideline in the previous standard which specified that the present value of minimum lease payments represents more than 90% of the asset's fair value. Paragraph 10(e) of *AASB 117* does not apply to this example.

One of the factors discussed in paragraph 11 is the cancellability of the lease. Pastor Ltd can cancel the lease, but has to pay a substantial penalty ($20 000) or enter into a new lease of equivalent amount and duration. These terms make it clear that cancellation is a very costly process and that the costs of cancellation fall on the lessee. Therefore, the lease is considered to be non-cancellable. The remaining two factors in paragraph 11 are not applicable.

The decision is clearly a matter of judgement that could be argued either way. Leaving this example aside, empirical evidence is that the overwhelming majority of leases reported on by Australian listed companies are classified as operating leases and recorded off-balance sheet.

6. Accounting for an operating lease by the lessee (H&P LO 12.7)

Operating lease payments are recognised by lessee as an expense on a straight line basis over the lease term unless another systematic basis is more representative of the pattern of use (AASB 117 para 33)

Disclosure requirements include total future minimum lease payments for all non-cancellable leases split into payments due before 1 year, after 1 year and before 5 years & later than 5 years (AASB 117 para 35)

Need to also consider AASB 7 disclosure requirements

7. Account for finance leases in the books of the lessee (H&P LO 12.8)
At the inception of the lease:
-The lessee shall recognise a lease asset and lease liability (AASB 117 para 20)
The asset and liabilities shall be initially recognised at (AASB 117 para 20):
-The fair value of the leased property; or, if lower,
The present value of the minimum lease payments using implicit interest rate
-Any initial direct costs are added to the amount recognised as an asset.
Lower: PV of MLP (includes initial direct costs)
Fair value

Initial recognition:
Dr Leased asset
Cr Lease Liability
Subsequent measurement:
Subsequent to initial recognition (AASB 117 para .25):
-The minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability
-The finance charge shall be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability
See disclosure requirements AASB117.31-32
Accounting entry to allocate each lease payment between principal and interest:
Dr Lease liability
Dr Interest expense
Cr Cash
Executory costs (i.e., recovery of maintenance or insurance costs by the lessor) are treated as an expense:
Dr Executory expenses
Cr Cash
Depreciate/amortise the capitalised lease asset:
This should be over the number of accounting periods the entity is expected to benefit from the asset's use in accordance with AASB 116 or AASB 138
• If reasonably certain lessee will obtain ownership, depreciate/amortise over the asset's useful life.
• If not reasonably certain, depreciate/amortise over the lease term (AASB 117 para 27)
Dr Depreciation/amortisation expense
Cr Accumulated depreciation/amortisation of leased asset
The impairment provisions of AASB 136 also apply to leased assets (AASB 117 para 30)
e.g. Tenfour Ltd agrees to lease a truck on 1/7/2016 involving the following terms

- annual payments of $20,000 paid on 30 June of each financial year for the next four years
- at the expiration of the lease, the lessee has guaranteed a residual value of $15,000
- the estimated useful life of the truck is 5 years
- the rate of interest implicit in the lease is 12%
- the fair value of the asset at inception is $70,280
- the lessee classifies it as a finance lease

Calculate the present value of the minimum lease payments:

Annuity of $20,000 in arrears for 4 years @12%:

$$PV = 20{,}000\frac{1-(1+12\%)^{-4}}{12\%} = 60{,}740$$

Guaranteed residual $15,000 payable at end of 4 yrs @ 12%:

$$PV = \frac{15{,}000}{(1+12\%)^4} = 9{,}540$$

Present value of the lease: 60,740+9,540=70,280

The initial entry to recognise the finance lease is:

| | | | |
|---|---|---|---|
| Dr | Leased truck | 70 280 | |
| Cr | Lease Liability | | 70 280 |

Assuming the truck is to be returned to the lessor at the end of the lease, it is depreciated on a straight-line basis over four years 30 June 2017-2020

| | | | |
|---|---|---|---|
| Dr | Depreciation expense | 17 570 | |
| Cr | Accum. depreciation - leased truck | | 17 570 |

Amortisation of lease liability & recording interest expense based on effective interest method:

| (1) Year | (2) PV of Liab | (3) Int. 12% x (2) | (4) Pay't | (5) Reduction in Liability (4) – (3) |
|---|---|---|---|---|
| 2017 | 70 280 | 8 434 | 20 000 | 11 566 |
| 2018 | 58 714 | 7 046 | 20 000 | 12 954 |
| 2019 | 45 760 | 5 491 | 20 000 | 14 509 |
| 2020 | 31 251 | 3 749 | 35 000 | 31 251 |

The journal entry to record the lease payment and the reduction in the lease liability in 2017 would be:

30 June 2017

| | | | |
|---|---|---|---|
| Dr | Interest expense | 8 434 | |
| Dr | Lease liability | 11 566 | |
| Cr | Cash | | 20 000 |

Extract from Balance Sheet – Tenfour Ltd

30 June 2017

Non-current assets

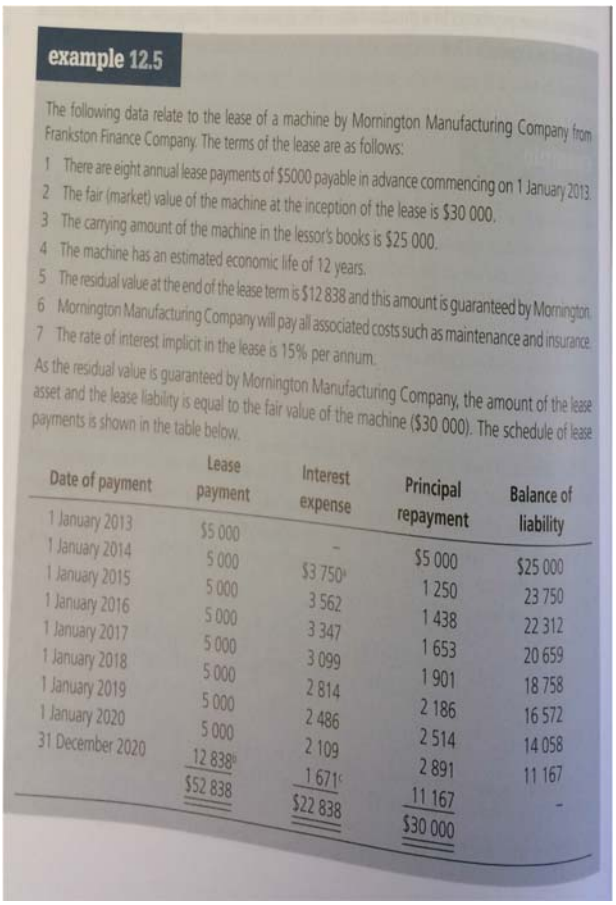
| | |
|---|---|
| Leased truck | 70,280 |
| - Accumulated depreciation | (17,570) |
| | 52,710 |

Current Liabilities

| | |
|---|---|
| Lease liability due 30 June 2018 | 12,954 |

Non-current Liabilities

| | |
|---|---|
| Lease liability due 30 June 2019-2020 | 45,760 |



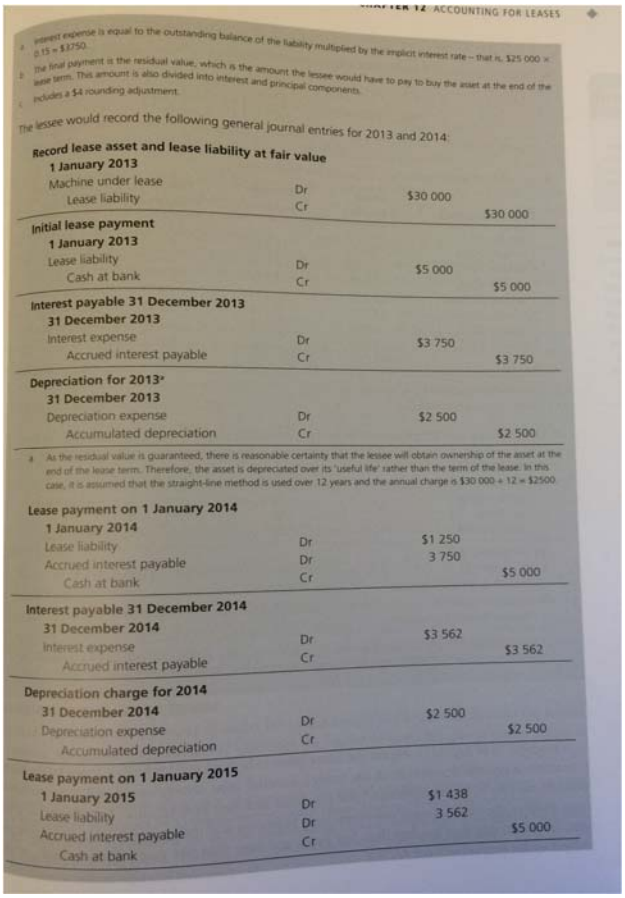
**example 12.5**

The following data relate to the lease of a machine by Mornington Manufacturing Company from Frankston Finance Company. The terms of the lease are as follows:

1. There are eight annual lease payments of $5000 payable in advance commencing on 1 January 2013.
2. The fair (market) value of the machine at the inception of the lease is $30 000.
3. The carrying amount of the machine in the lessor's books is $25 000.
4. The machine has an estimated economic life of 12 years.
5. The residual value at the end of the lease term is $12 838 and this amount is guaranteed by Mornington.
6. Mornington Manufacturing Company will pay all associated costs such as maintenance and insurance.
7. The rate of interest implicit in the lease is 15% per annum.

As the residual value is guaranteed by Mornington Manufacturing Company, the amount of the lease asset and the lease liability is equal to the fair value of the machine ($30 000). The schedule of lease payments is shown in the table below.

| Date of payment | Lease payment | Interest expense | Principal repayment | Balance of liability |
|---|---|---|---|---|
| 1 January 2013 | $5 000 | – | $5 000 | $25 000 |
| 1 January 2014 | 5 000 | $3 750[a] | 1 250 | 23 750 |
| 1 January 2015 | 5 000 | 3 562 | 1 438 | 22 312 |
| 1 January 2016 | 5 000 | 3 347 | 1 653 | 20 659 |
| 1 January 2017 | 5 000 | 3 099 | 1 901 | 18 758 |
| 1 January 2018 | 5 000 | 2 814 | 2 186 | 16 572 |
| 1 January 2019 | 5 000 | 2 486 | 2 514 | 14 058 |
| 1 January 2020 | 5 000 | 2 109 | 2 891 | 11 167 |
| 31 December 2020 | 12 838[b] | 1 671[c] | 11 167 | – |
| | $52 838 | $22 838 | $30 000 | |



a Interest expense is equal to the outstanding balance of the liability multiplied by the implicit interest rate – that is, $25 000 × 0.15 = $3750.

b The final payment is the residual value, which is the amount the lessee would have to pay to buy the asset at the end of the lease term. This amount is also divided into interest and principal components.

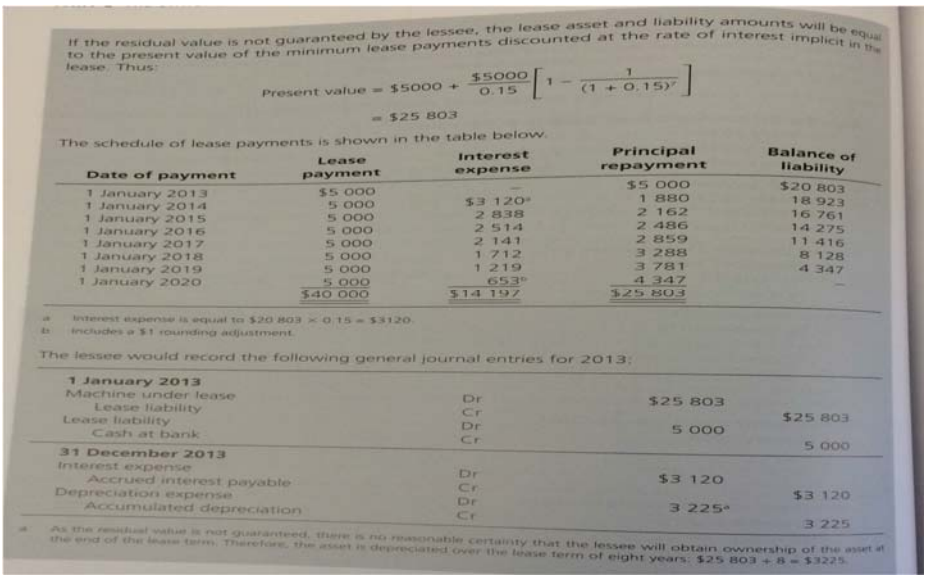
c Includes a $4 rounding adjustment.



The lessee would record the following general journal entries for 2013 and 2014:

| | | | |
|---|---|---|---|
| **Record lease asset and lease liability at fair value** | | | |
| **1 January 2013** | | | |
| Machine under lease | Dr | $30 000 | |
| Lease liability | Cr | | $30 000 |
| **Initial lease payment** | | | |
| **1 January 2013** | | | |
| Lease liability | Dr | $5 000 | |
| Cash at bank | Cr | | $5 000 |
| **Interest payable 31 December 2013** | | | |
| **31 December 2013** | | | |
| Interest expense | Dr | $3 750 | |
| Accrued interest payable | Cr | | $3 750 |
| **Depreciation for 2013[a]** | | | |
| **31 December 2013** | | | |
| Depreciation expense | Dr | $2 500 | |
| Accumulated depreciation | Cr | | $2 500 |
| **Lease payment on 1 January 2014** | | | |
| **1 January 2014** | | | |
| Lease liability | Dr | $1 250 | |
| Accrued interest payable | Dr | 3 750 | |
| Cash at bank | Cr | | $5 000 |
| **Interest payable 31 December 2014** | | | |
| **31 December 2014** | | | |
| Interest expense | Dr | $3 562 | |
| Accrued interest payable | Cr | | $3 562 |
| **Depreciation charge for 2014** | | | |
| **31 December 2014** | | | |
| Depreciation expense | Dr | $2 500 | |
| Accumulated depreciation | Cr | | $2 500 |
| **Lease payment on 1 January 2015** | | | |
| **1 January 2015** | | | |
| Lease liability | Dr | $1 438 | |
| Accrued interest payable | Dr | 3 562 | |
| Cash at bank | Cr | | $5 000 |

a As the residual value is guaranteed, there is reasonable certainty that the lessee will obtain ownership of the asset at the end of the lease term. Therefore, the asset is depreciated over its 'useful life' rather than the term of the lease. In this case, it is assumed that the straight-line method is used over 12 years and the annual charge is $30 000 ÷ 12 = $2500.



If the residual value is not guaranteed by the lessee, the lease asset and liability amounts will be equal to the present value of the minimum lease payments discounted at the rate of interest implicit in the lease. Thus:

$$\text{Present value} = \$5000 + \frac{\$5000}{0.15}\left[1 - \frac{1}{(1 + 0.15)^7}\right]$$

$$= \$25\,803$$

The schedule of lease payments is shown in the table below.

| Date of payment | Lease payment | Interest expense | Principal repayment | Balance of liability |
|---|---|---|---|---|
| | | – | $5 000 | $20 803 |
| 1 January 2013 | $5 000 | $3 120[a] | 1 880 | 18 923 |
| 1 January 2014 | 5 000 | 2 838 | 2 162 | 16 761 |
| 1 January 2015 | 5 000 | 2 514 | 2 486 | 14 275 |
| 1 January 2016 | 5 000 | 2 141 | 2 859 | 11 416 |
| 1 January 2017 | 5 000 | 1 712 | 3 288 | 8 128 |
| 1 January 2018 | 5 000 | 1 219 | 3 781 | 4 347 |
| 1 January 2019 | 5 000 | 653[b] | 4 347 | – |
| 1 January 2020 | $40 000 | $14 197 | $25 803 | |

a Interest expense is equal to $20 803 × 0.15 = $3120.
b Includes a $1 rounding adjustment.

The lessee would record the following general journal entries for 2013:

| | | | |
|---|---|---|---|
| **1 January 2013** | | | |
| Machine under lease | Dr | $25 803 | |
| Lease liability | Cr | | $25 803 |
| Lease liability | Dr | 5 000 | |
| Cash at bank | Cr | | 5 000 |
| **31 December 2013** | | | |
| Interest expense | Dr | $3 120 | |
| Accrued interest payable | Cr | | $3 120 |
| Depreciation expense | Dr | 3 225[a] | |
| Accumulated depreciation | Cr | | 3 225 |

a As the residual value is not guaranteed, there is no reasonable certainty that the lessee will obtain ownership of the asset at the end of the lease term. Therefore, the asset is depreciated over the lease term of eight years: $25 803 ÷ 8 = $3225.

8. Understand the proposed new approach to lease accounting (H&P LO 10 pp 378-380 & Additional readings on BB)

Project has been undertaken due to dissatisfaction with existing lease accounting standard

›Operating/finance lease distinction be removed so off balance sheet leases will disappear

›Lease agreements in excess of 12 months be recognised as "right to use" asset & "obligation to pay rentals" liability based on PV of lease payments discounted with lessee' s incremental borrowing rate