FINANCIAL ACCOUNTING 700 Seminar RS 2 – Suggested solutions *PH Ferreira*	DEPARTMENT OF ACCOUNTING UP

SEMINAR 2

SUGGESTED SOLUTION TO QUESTION 1

a. Brands

The brands clearly meet the definition of an asset, as:

- they have arisen as a result of past events (advertising, service, quality, etc.);
- they are resources controlled by ASB (ASB may, for example, change or sell these brands);
- they are likely to give rise to a future economic inflow (by means of beer sales).

As regards the recognition criteria, there is no problem regarding the probability of future economic benefits, but the problem relates to measurability. It is virtually impossible to ascertain the value of the brands in future.

The problem is that the brands are internally generated, with the result that their expenditure cannot be distinguished from the cost of developing the business as a whole. Had they been purchased in an arms length transaction, the value would have been ascertainable.

The brands should therefore not be capitalised onto the statement of financial position. [Refer to IAS 38 later in the year].

b. Post retirement costs

Post retirement medical aid contributions satisfy the definition of a liability as they:

- are a present obligation [the fact that the obligation is not legally binding is of no relevance, the policy of the company gives rise to a constructive obligation];
- arise from a past event [namely the company's past practice, as well as the services rendered by employees];
- will give rise to a probable outflow of economic benefit [namely the outflow of cash when the contributions are paid].

The amounts are both measurable (although determinable only by means of actuarial methods) and probable (the employees will definitely remain with the medical fund after retirement) and therefore the recognition criteria are also satisfied and the liability should be provided for.

Note: The seminar on Employee Benefits deals with this issue in greater detail.

c. Factoring of debtors

As the factor has no recourse in the event of a debtor defaulting, the debtors should be derecognised in their entirety. The difference between the carrying amount of R400 000 and the proceeds of R360 000 should be recognised in profit or loss, as there is a depletion in an asset resulting in a reduction in equity. This will result in an expense of R40 000. Furthermore, as factoring is without recourse, no liability or contingent liability to the factor exists. As a result, no liability needs to be raised in respect of the proceeds received.

Note: The seminar on Financial Instruments deals with this issue in greater detail.

SUGGESTED SOLUTION TO QUESTION 2

An item can only be recognised as an asset or liability if it satisfies the following two criteria:

- It is probable that a future economic benefit associated with the item will flow to or from the entity.
- The item has a cost or value that can be measured with reliability.

Furthermore, to be recognised as an asset, the item must meet the definition of an asset as defined by The Conceptual Framework:

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

Similarly, to be recognised as a liability, the item must meet the definition of a liability as defined by The Conceptual Framework:

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

The above is applicable to all of the parts below:

a. **Advertising costs**

The benefits which will flow to the entity from the cost incurred is not possible to predict with any degree of reliability. The probability that future economic benefits will flow to the entity can therefore not be determined. Consequently, these costs may not be capitalised. [It should also be noted that IAS 38.69(c) prohibits capitalisation of these expenses.]

b. **Provision for future reconstruction costs**

For the provision to be made, there must be a present obligation (being a legal or constructive obligation). Only once the company is irrevocably committed to the reconstruction (ie. there is no turning back), can the provision be made as it is then, and only then, that the company has a present obligation. The company is irrevocably committed when it has raised a valid expectation that the plan will be carried out, by starting to implement the plan or announcing its main features to those affected by it. Also refer to IAS 37.70 – .83 in this regard.

c. **Research costs**

It is not possible to predict, with any degree of reliability, the benefits which will flow to the entity from the research costs incurred. These costs may thus not be capitalised. Furthermore, IAS 38.54 specifically states that research costs should be regarded as expenses.

d. **Internally generated goodwill**

These costs do not meet the definition of an asset as there is no identifiable resource controlled by the entity. Furthermore, the costs incurred and the prediction of the possible benefits cannot be made with any degree of reliability, resulting in the recognition criteria not being met. Thus no asset can be recognised in the financial statements of the company. IAS 38.48 specifically states that internally generated goodwill may not be recognised as an asset.

e. **Purchased goodwill**

Purchased goodwill meets the definition of an asset. It is possible to measure the cost of purchased goodwill, as the cost of the business is known and the fair value of the net assets acquired can be reliably obtained. The recognition criteria are met and thus an asset can be recognised in the financial statements of the company. Also refer to IFRS 3 in this regard.

f. **Revenue received in advance**

There are two situations here:

1. The amount is refunded if the service is not rendered

   Here, the amount should be treated as a liability as it meets the definition of a liability and the recognition criteria.

2. The amount is not refundable

   If one strictly adheres to The Conceptual Framework, revenue received in advance, which is not refundable, should be treated as income in the year that it arose, as it does not meet the definition of a liability as there is no obligation to the entity. However, the standard setters realised that this would not result in the fair presentation of the performance of the entity and, as a result, IAS 18 states that this amount should be deferred. This is achieved by using the stage of completion method to recognise revenue resulting from the rendering of services.

g. **Provision for future maintenance**

Future maintenance costs do not represent a liability, as there is no present obligation to the entity. A provision can thus not be made. However, if these expenses are recognised in profit or loss every two years when incurred, fair presentation would not be achieved, as economic benefits are derived from these expenses every single year. IAS 16.43 has attempted to overcome the problem by stating that the different major components of plant and equipment should be depreciated over the different lives of each component. Therefore the maintenance costs should be regarded as a separate component and depreciated over a two-year period. Also refer to IAS 16.14 regarding major inspection costs.

h. **Provision for warranties**

The costs of repairing or replacing all items that manifest manufacturing defects cannot be avoided. This represents a present obligation. As long as a reasonable estimate of the obligation can be made, a provision should be recognised. The estimate may for example be based on past experience. In respect of this year's sales, the obligation provided for at the reporting date is the cost of making good items for which defects have been notified but not yet processed, plus an estimate of costs in respect of the other items sold for which there is sufficient evidence that manufacturing defects will manifest themselves during their remaining periods of warranty cover. Also refer to IAS 37 in this regard.

SUGGESTED SOLUTION TO QUESTION 3

One of the underlying assumptions is that financial statements are prepared on the accrual basis. This requires the effects of transactions and other events to be recognised when they occur. The recognition of losses before they are incurred is contrary to this concept.

Future losses do not fall within the definition of expenses. The decrease in economic benefits in the form of outflows of assets or increases in liabilities cannot be recognised prior to the loss being incurred, since both the definitions of assets and liabilities refer to past events.

IAS 37.63 furthermore specifically states that provisions shall not be recognised for future operating losses.

SUGGESTED SOLUTION TO QUESTION 4

The instrument issued on 1 July 2008 is a convertible cumulative preference share bearing compulsory dividends.

Since the recognition criteria have been satisfied, one need only determine what element of the financial statements it represents (1) in terms of the Conceptual Framework.

The compulsory preference dividends represent a present obligation of the entity (compulsory dividends have to be paid), (1) as a result of a past event (the shares were issued on 1 July 2008) (1) that would give rise to an outflow of economic benefits (dividends will be paid to parties outside Met Ltd) (1) – this indicates that the dividend portion of the compulsory cumulative convertible preference shares is a liability in terms of the Conceptual Framework. (1)

In addition to the compulsory cumulative preference dividends, the instrument also contains a compulsory conversion feature that would force the entity to convert the preference shares to ordinary shares on 30 June 2012. (1)

This represents equity in respect of this instrument, as it is the residual interest of the assets received by the entity after deduction all its associated liabilities (1). The entity received cash when the preference shares were issued (½) and this should be reduced by the liability component associated with the compulsory, cumulative dividend payments (1). The remainder, a residual, is therefore equity. (½).

At initial recognition the entity should therefore split the proceeds received between a liability component in respect of the compulsory preference dividend and an equity component of the rest. (1)

SUGGESTED SOLUTION TO QUESTION 5

IAS/ IFRS: Entities should comply with the IAS's/ IFRS's if their financial statements purport to be prepared in compliance with International Financial Reporting Standards.

SIC/ IFRIC: These Interpretations have the same authority as International Financial Reporting Standards and should be read in conjunction with the relevant standard.

AC 500 series: These Standards/Interpretations relate to the South African context and have the same authority as the IAS/IFRS's and SIC/IFRIC's.

Circulars: The status of a circular depends on the objective for which it was issued together with the content thereof.

Exposure drafts: These documents have no standing in themselves as they are issued merely to elicit public comment.