Issues in Financial Reporting and Analysis (ACCT3563)

Accounting for Assets

Required readings

- **Deegan chapters 4, 5, 6 & 8**
- **AASB 116**
- **AASB 123**
- **AASB 136**
- **AASB 138**

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Learning Objectives

- **Recognition and measurement issues in accounting for non-current physical assets in the balance sheet including**
  - meaning of cost of acquisition
  - the role of valuations
  - impairment
  - borrowing costs
- **Accounting for intangible assets**
  - identifiable intangibles versus goodwill
  - recognition and measurement rules
  - research and development costs
- **Goodwill impairment**
- **Comparison between accounting for physical assets and accounting for intangible assets**

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Assets: Definition

Definition

AASB Framework (par. 49):
Resource **controlled** by an entity as a result of past events and from which future economic benefits are expected to **flow to** the entity.

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Assets: Recognition Criteria

Recognition criteria

Under AASB Framework (par. 89) an asset is to be recognised in the balance sheet only when:

- it is **probable** that future economic benefits embodied in the asset will flow to the entity; and
- the asset possesses a cost or other value that can be measured **reliably**.

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Proposed change in the definition of an Asset

- IASB's proposed definition:

"*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.*"

-> Remove "probable", "expected" inflow
-> The focus on rights.

What are the implications?

For more info: http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Discussion-Paper-July-2013/Documents/AP3%20London-%20asset%20and%20liability%20definitions%20recognition%20and%20derecognition.pdf

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Assets: Measurement

- **Various measurement rules**
  - Property or plant: cost basis or fair value basis
  - Purchased goodwill: cost basis

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Property, Plant and Equipment (PPE)

- **They are (AASB 116):**
  - **tangible items**
  - held for use in the production or supply of goods or services, for rental to others, or for administrative purposes
  - expected to be used during **more than one period**
- **They are measured initially at 'cost', which includes:**
  - purchase price
  - any costs directly attributable to bringing the asset to operating condition and location
  - initial estimates of the costs of dismantling and removing the item and restoring it

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PPE (Initially measurement)

AASB 116, para 6 defines cost as

- Amount of cash or cash equivalents paid OR
- FV of other consideration **given** to acquire an asset at the time of its acquisition or construction

AASB 116, para 23 -> If cash payment is delayed

- Cost = cash price equivalent at recognition date
- Measure cash payment on a PV basis
- The interest on deferred payment is expensed unless it can be capitalised in accordance with AASB 123

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PPE (Initially measurement)

- **AASB 123 'Borrowing Costs'**
  - interest and other costs incurred by an entity in connection with the borrowing of funds
  - recognised as **expense** except to the extent that directly attributable to the acquisition, construction or production of a qualifying asset in which case capitalise into cost of asset
- **Qualifying asset**
  - an asset that necessarily takes a substantial period of time to get ready for its intended use or sale
  - 'substantial period of time' — generally more than 12 months
  - capitalisation of borrowing costs ceases when substantially all the activities necessary to prepare the asset for its intended use or sale are complete (more on this in future topics)

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PPE (Subsequent Measurement)

- **For each class of PPE an entity must choose:**
  - the cost model or
  - the revaluation model
- **The cost model**
  - Cost
  - Less: Accumulated depreciation
  - Less: **Accumulated impairment losses**
- **The revaluation model**
  - Fair value at date of revaluation
  - Less: Accumulated depreciation after revaluation
  - Less: Accumulated impairment losses **after revaluation**

(NB: impairment applies to both models)

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The Use of Fair Values

AASB116 (para 31) requires that revaluations must be made with sufficient regularity so the carrying amount of each asset in the class does not differ materially from fair value.

- **Measurement at fair value**
  - Price in a binding arms-length sale agreement
  - Price in active market
  - Recent transactions for similar assets in the same industry
  - Going concern basis not forced sale
  - Use market-based evidence where available e.g. appraisal of land and buildings by professionally qualified valuers
  - Use income or depreciated replacement cost approach if no market-based evidence

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Revaluation Increments

- **Accounting for revaluation increments**
  - Asset by asset basis
  - Increase carrying amount above **written down cost** and recognise increment to reserve

    DR PPE
    CR Revaluation reserve

  ! Revaluation reserve is an **equity** balance

- **Any balance of accumulated depreciation at the date of revaluation must be accounted for either using:**
  - The net method – credited the accum depn to the gross balance of the asset account prior to revaluation, or
  - The gross method – restated the accum depn proportionately with the change in gross carrying amount of the asset, so the carrying amount after revaluation equals the revalued amount

This subject applies the net method

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Revaluation Increments

- **Journal entries (net method)**
  - Step 1 offset accumulated depreciation against cost

    Dr Accumulated depreciation
    Cr PPE

  - Step 2 revalue the asset up from its carrying amount to its fair value, the increment goes to an equity account

    Dr PPE
    Cr Revaluation reserve

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Revaluation Decrements

- **Accounting for revaluation decrements**
  - Decrease carrying amount below written down cost and recognise decrement in the profit or loss

    DR **Loss on revaluation of asset** (P&L)
    CR PPE

- **Netting off is NOT allowed across items**
  - Example:
    - some items give rise to revaluation increments - reserve;
    - some give rise to revaluation decrements - profit or loss.

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Reversals of revaluation de/increments

- **A revaluation decrement for an asset in a prior period recorded to profit and loss**
  - The reversal arises if there is a revaluation decrement in the current period for the same asset:

    DR PPE
    CR Gain on revaluation (**the reversal in the P&L**)
    CR Revaluation reserve (**any excess cr to equity**)

- **A revaluation increment for an asset in a prior period recorded to reserve**
  - The reversal of increments arises if there is a revaluation decrement in the current period for the asset that had occurred revaluation increment in a prior period:

    DR Revaluation reserve (**the reversal dr to equity**)
    DR Loss on revaluation (**any excess in the P&L**)
    CR PPE

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Example of revaluation and reversals

B Ltd is a manufacturing company that acquired a substantial land portfolio on 1 July 20X3. Relevant information is set out below.

Land	Cost ($)	Fair value ($)	Fair value ($)
	1.7.X3	30.6.X4	30.6.X5
NSW	1,500,000	2,000,000	1,800,000
Victoria	250,000	230,000	280,000
Queensland	740,000	590,000	610,000
South Australia	580,000	600,000	650,000
	3,070,000	3,420,000	3,340,000

B Ltd uses the fair value basis for the subsequent measurement of land. What journal entries are required for 30 June 20X4 and 30 June 20X5?

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B Ltd

General journals 30.6.X4

Dr. Land – NSW	**$500,000**
Cr. Asset revaluation reserve	**$500,000**
Dr. Loss on revaluation	**$20,000**
Cr. Land – Victoria	**$20,000**
Dr. Loss on revaluation	**$150,000**
Cr Land – Queensland	**$150,000**
Dr. Land – South Aust	**$20,000**
Cr. Asset revaluation reserve	**$20,000**

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B Ltd

Land	Cost ($)	Fair value ($)	Fair value ($)
	1.7.X3	30.6.X4	30.6.X5
		Reversal of equity, no excess	
NSW	1,500,000	2,000,000	1,800,000
		Reversal of loss through gain, excess goes to equity	
Victoria	250,000	230,000	280,000
		Reversal of loss through gain, no excess	
Queensland	740,000	590,000	610,000
		No reversal, value continues to go up	
South Australia	580,000	600,000	650,000
	3,070,000	3,420,000	3,340,000

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B Ltd

General journals 30.6.X5

Dr. Asset revaluation reserve	$200,000
Cr. Land – NSW	$200,000
Dr. Land – Victoria	$50,000
Cr. Gain on revaluation	$20,000
Cr. Asset revaluation reserve	$30,000
Dr. Land – Queensland	$20,000
Cr. Gain on revaluation	$20,000
Dr. Land – South Aust	$50,000
Cr. Asset revaluation reserve	$50,000

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Accounting for profit on disposal of revalued PPE

- **When PPE is sold, the balance in the revaluation reserve attributable to the item**
  - may be transferred directly to capital profits reserve
  - may be transferred to retained profits
  - cannot be transferred to the profit and loss
- **The gain or loss on sale depends on whether the cost basis or revaluation basis has been applied**
  - gain on sale will be **less** for an item that has previously been revalued above cost (be mindful of the long-term income effect)

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Economic consequences of revaluations

- **If contracts in place are tied to reported profits, management might have an incentive ?_____ because of the flow on effect of higher depreciation**
- **Revaluation of assets might ?_____ constraints such as debt-to-assets restrictions**
- **Measurement of fair values may be costly**

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Changing between cost basis and revaluation basis

- **An entity shall select and apply its accounting policies consistently**
- **AASB 108, Change an accounting policy only if:**
  - Required by Australian Accounting Standard
  - Results in financial report providing reliable and more relevant information
- **Revaluation basis change back to cost basis will be rare**

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Impairment

- **AASB136 specifies that entities are required to conduct impairment tests to ensure their assets are not overstated.**
- **Impairment results when an asset's carrying amount (CA) is more than its recoverable amount (RA).**
- **Evidence of impairment**

External sources	Internal sources
Decline in market value	Obsolescence or physical damage
Adverse changes in entity's environment/market	Change in asset use
Increases in interest rates	An asset's economic performance being worse than expected
Market capitalisation	

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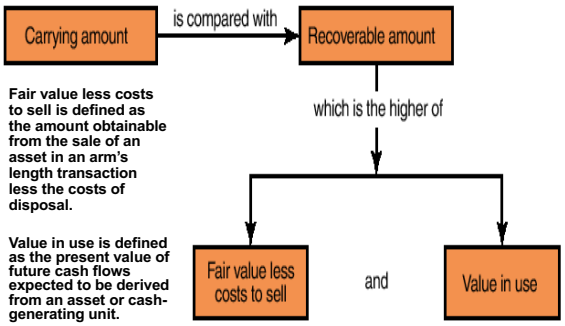
Impairment test for an individual asset



Fair value less costs to sell is defined as the amount obtainable from the sale of an asset in an arm's length transaction less the costs of disposal.

Value in use is defined as the present value of future cash flows expected to be derived from an asset or cash-generating unit.

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Recognition of Impairment Loss

- **An impairment loss is recognised where CA > RA**
- **Where the asset is accounted for under the cost model the impairment loss is recognised immediately in *Profit & Loss.***
- **Where the asset is accounted for under the revaluation model the impairment loss is treated as a *revaluation decrement* (AASB 136, para 60) and recognised against that asset's revaluation reserve, the amount is capped at =<*ARR* (AASB 136, para 61).**
- **Any subsequent depreciation/amortisation is based on the new recoverable amount.**

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Impairment Loss: Example 1

Cost model

- An asset has a CA of $100 (cost of $160 – accum dep'n of $60) and a RA of $90. *The journal entry to record the impairment loss would be:*

Dr	**Impairment loss**	**10**	
Cr	**Accumulated depreciation & impairment losses**		**10**

Revaluation model

- An asset has a cost of $120 (accum dep'n of $20) and a RA of $90. This asset was previously revalued upwards by $50. *The journal entries to record the impairment loss would be:*

Dr	**Accumulated depreciation**	**20**	
Cr	**Asset**		**20**
Dr	**Asset revaluation reserve**	**10**	
Cr	**Asset**		**10**

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Reversal of Impairment Loss

- **Cost model**

Dr	**Accumulated depreciation & impairment losses**	**xx**	
Cr	**Income – gain on reversal of impairment loss**		**xx**

- **Revaluation model**
  - **Where the impairment loss was taken to the P&L the journal entry would be the same as that shown above under the cost model**
  - **Where the impairment loss was taken against the ARR the journal entry to record the reversal of the impairment loss would be:**

Dr	**Asset**	**xx**	
Cr	**Asset revaluation reserve**		**xx**

- **The CA of an asset cannot be increased above the lower of:**
  - **its RA (if determinable)**
  - **the CA that would have been determined had no impairment loss been recognised in prior periods.**

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Impairment Loss: Example 2

Refer to the data in B Ltd example above. Assume B Ltd used the *cost basis* for subsequent measurement of land. Assume costs to sell are zero and value in use cannot be reliably determined at this stage (hint: use fair value as RA).

What journal entries would be required for 30 June 20X4 and 30 June 20X5 in this case?

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B Ltd

Land	Cost ($)	Fair value ($)	Fair value ($)
	1.7.X3	30.6.X4	30.6.X5
	CA<RA, not impaired, do nothing		
NSW	1,500,000	2,000,000	1,800,000
		CA>RA, impaired	
Victoria	250,000	230,000	280,000
		CA>RA, impaired	
Queensland	740,000	590,000	610,000
	CA<RA, not impaired, do nothing		
South Australia	580,000	600,000	650,000
	3,070,000	3,420,000	3,340,000

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Impairment Loss: Example 2

30.06.X4

Dr. Impairment loss **$20,000**
Cr. Accumulated impairment losses on Land – Victoria **$20,000**

Dr. Impairment loss **$150,000**
Cr. Accumulated impairment losses on Land – Queensland **$150,000**

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B Ltd

Land	Cost ($)	Fair value ($)	Fair value ($)
	1.7.X3	30.6.X4	30.6.X5
		CA=1.5M, RA=1.8M; CA<RA, not impaired, do nothing	
NSW	1,500,000	2,000,000	1,800,000
		CA<RA, not impaired but can reverse through gain	
Victoria	250,000	230,000	280,000
		CA<RA, not impaired but can reverse through gain	
Queensland	740,000	590,000	610,000
		CA=580K, RA=650K; CA<RA, not impaired, do nothing	
South Australia	580,000	600,000	650,000
	3,070,000	3,420,000	3,340,000

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Impairment Loss: Example 2

30.06.X5

Dr. Accumulated impairment losses on Land – Victoria **$20,000**
Cr. Gain on reversal of impairment loss **$20,000**

Dr. Accumulated impairment losses on Land – Queensland **$20,000**
Cr. Gain on reversal of impairment loss **$20,000**

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Impairment losses and CGUs

- **A Cash Generating Unit is defined as "the smallest identifiable group of assets (generating cash flows from continuing use) that are independent of the cash inflows from other assets or groups of assets".**
- **Where an impairment loss arises in a CGU with no goodwill the loss is allocated across all of the assets in the CGU on a pro-rata basis based on the CA of each asset relative to the total CA of the CGU.**
- **Where an impairment loss arises in a CGU with goodwill the following allocation rules apply:**
  - to reduce the carrying amount of the **CGU's goodwill to zero;**
  - to the other assets of the CGU on a pro rata basis (on the same basis as discussed above).
- **Reversal of impairment loss in a CGU:**
  - Impairment losses relating to goodwill **cannot** be reversed.
  - The reversal of any impairment loss relating to a CGU is allocated across the assets of the CGU (excluding goodwill) on a pro-rata basis.

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The tangible/intangible distinction

- **Tangible asset (AASB 116)**
  - A physical object which is tangible i.e. capable of being touched.
- **Intangible asset (AASB)**
  - Identifiable non-monetary asset without physical substance.

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The tangible/intangible distinction in accounting recognition

- Tangible assets more likely to satisfy recognition criteria due to the greater certainty regarding future benefits.
- Tangibility (physical form) not an essential characteristic of an asset *(AASB Framework para.56)*.
- Identifiable non-monetary asset without physical substance can embody future economic benefits, even though they do not have physical substance, e.g.,
  - Patents, Copyrights and Intellectual property,
  - Licenses and Franchises,
  - Research and development,
  - Computer software, Motion picture films,
  - Taxi licenses.

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Intangible Assets

- Excludes:
  - Intangibles covered by another standard. e.g.,
    - Intangible assets held for sale (AASB 102)
    - Deferred tax assets (AASB 112)
    - Leases (AASB 117)
  - Financial assets (AASB 139, AASB 9)
  - Mineral rights, mining and extractive resources expenditure (AASB 6)
- Goodwill is dealt with in AASB 3.

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Intangibles: Requirements

- Identifiability
  - separable - divided from the entity for sale etc.,
  - arises from contractual or other legal rights,
- Control
- Future Economic Benefit

And where:

- it is probable that the economic benefits will flow to the entity, and
- the cost can be reliably measured.

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Intangibles: Identifiable Versus Unidentifiable

- Identifiable intangible assets
  - e.g. trademarks, patents, licenses, etc.
- Unidentifiable intangible assets
  - intangible assets that cannot be separately sold e.g. goodwill
- Does it matter?
  - Yes! - Accounting rules differ for un/identifiable intangible assets

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How are intangibles acquired?

Purchased Intangibles

- Purchased intangibles are recognised at cost (AASB 138 para.24).
- Revaluation to fair value is restricted to assets in which there is an active market (not goodwill) (AASB 138 p.81).
- Require amortisation and impairment testing.

Internally generated

- Prohibition on recognition of certain internally generated intangibles (paras.63 & 48)
  - Brands
  - Mastheads
  - Publishing titles
  - Customers lists
  - Other similar items
  - Goodwill

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Initial Recognition

- Purchased Intangibles
  - Usually recognised because have a cost that can be reliably measured.
  - Measured and recognised at cost (AASB 138, para.24).
- Internally Generated Intangibles
  - Recognition problematic because in many cases cost/value cannot be reliably measured.
  - Some can be recognised, e.g.,
    - patents, copyrights and intellectual property,
    - licenses and franchises,
    - recipes and designs,
    - R&D, but is recognised only in the development phase (not research phase) and must meet certain conditions.

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Internally generated intangible assets NOT recognised

- Expenditure on items that cannot be distinguished from the cost of developing the business as a whole, may not be recognised. These include (AASB138, para 64):
  - Brands
  - Mastheads
  - Publishing titles
  - Customer lists
- Internally generated goodwill can also not be recognised.

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Intangible assets with *finite* useful lives

- Useful life may be limited. e.g.,
  - Contractual or legal rights
  - Product life cycle
  - Obsolescence
- Amortised over the useful life
  - Time or units of production

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Intangible assets with *indefinite* useful lives

- Indefinite useful life (no foreseeable limit to cash generating capabilities of the asset)
  - shall NOT be amortised (AASB 138 para.107);
  - must be tested for asset impairment as per AASB 136 annually or when impairment is indicated (para.108);
  - indefinite useful life must be re-assessed at each reporting period (para.109).

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Measurement after recognition

- Like other assets, for (identifiable) intangible assets, we can choose to use either:
  - Cost model
  - Revaluation model

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Revaluation of identifiable Intangibles?

- Permitted providing there is an active market (AASB 138 para.75)
  - The revaluation model allows an intangible asset to be carried at its fair value less any subsequent accumulated amortisation and any subsequent accumulated impairment.
- Definition of an active market is one in which all the following conditions exist:
  - the items traded in the market are homogeneous;
  - willing buyers and sellers can normally be found at any time; and
  - prices are available to the public (AASB 138 para.8).

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Revaluation of identifiable Intangibles?

- Active markets exist for freely exchanged assets such as taxi licences, but **not** for unique assets such as mastheads, trademarks, brands.
- Revaluation not permitted if no active market.
- Therefore, revaluations could occur, but the condition of an active market won't apply often because the value of most intangibles is driven by their uniqueness (AASB 138 para.78).

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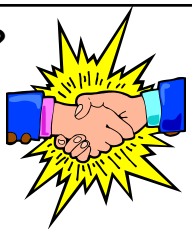
What is goodwill?



- Nature of goodwill
  - Market penetration
  - Effective advertising
  - Good labour relations
  - A superior operating team
  - Unidentifiable intangible asset
- Goodwill may be internally generated or acquired by purchasing an existing business.

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Internally Generated Versus Purchased Goodwill

- Internally generated goodwill shall **not** be recognised as an asset (AASA 138 para.48).
- Therefore, only **purchased goodwill** will be recognised
  - Purchased goodwill can be measured more reliably than internally generated goodwill, based on the amount paid;
  - Arises when one entity acquires another entity, or part thereof.
- Purchased goodwill is measured as the excess of the cost of acquisition incurred over the net fair value of the assets, liabilities and contingent liabilities acquired (AASB 3 para.51).

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Measuring purchased goodwill subsequent to acquisition

- Questions about Goodwill measurement:
  - Amortised? NO!
  - Revaluation? NO!
  - Impairment ?
- Impairment testing of goodwill to occur annually and more often if impairment is indicated, as per AASB 136 para.10.
- After initial recognition, goodwill is to be measured at cost less any accumulated impairment losses.

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Research and Development (R&D)

- Purpose:
  - Acquiring new knowledge or
  - Developing a new product or
  - Improving existing product

- Internally generated intangible assets

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Research and Development (R&D)

- Definition of research:
  - original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- Definition of development:
  - 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.

From AASB 138, para.8

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Research phase vs. Development phase

- In order to be classified in a Development Phase, the intangible asset benefit must be (satisfy all of the following, AASB138 para.57):
  - technically feasible, eventually being available for use or sale;
  - the entity has an intention to complete;
  - the ability to use or sell;
  - the availability of resources (technical, financial and other);
  - demonstrate how the asset will generate probable future economic benefits;
  - the ability to reliably measure the expenditure attributable to the asset.

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Research and Development Expenditure

- The accounting for R&D activity is determined by the "Phase" the activity is classified into.
- All costs incurred in the **Research Phase** must be expensed. (AASB 138 para.54).
- An intangible asset may result from activities in the **Development Phase** where they meet the requirements.
- Recognise **to the extent** that those costs are less than the **probable** future economic benefits from the intangible asset, and can be reliably measured [AASB 138 paras.21&22].
- Once expensed, it can not form part of the cost of an intangible asset at a later date (AASB 138 para.71).

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Costs included as part of an Internally Generated Intangible Asset

- All directly attributable costs necessary to create, produce and prepare the asset (AASB 138 para. 66)
  Including:
  - Materials and services consumed
  - Salaries, wages and other related costs of personnel
  - Fees to register a legal right

  But not: (AASB 138 para.67)
  - Selling, administrative and other general overheads unless directly attributable
  - Inefficiencies identified and pre-production losses
  - Training costs

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Research and development

- **Normative Analysis**
  - Why should research costs never be recognised as an asset if in fact the costs lead to subsequent economic benefits.
  - Is consistent with AASB Framework (para.87) an item that, at a particular point in time, fails to meet the recognition criteria may qualify for recognition at a later date as a result of subsequent circumstances or events?
- **Positive analysis**
  - Requiring write-off of R&D expenditure caused smaller US R&D firms to **reduce** R&D expenditure.
  - Requiring write-off of research might affect management decisions about research expenditure if management compensation is based on **profits.**

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Physical Assets vs. Intangibles

	Physical Assets	Intangibles
definition	held for use in the production or supply of goods or services, for rental to others, or for administrative purposes	identifiable non-monetary assets without physical substance
recognition	probable future economic benefits and reliable measurement of costs	probable future economic benefits and reliable measurement of costs
specific characteristics		internally generated development assets must satisfy all recognition criteria (para. 57) for a compulsory capitalisation
initial measurement	at cost	at cost
subsequent measurement	cost model or revaluation model; impairment test	cost model or revaluation model (but only if active market exists); impairment test

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Example and Revision

Revision Quiz

1. Can you recognise internally generated identifiable intangible assets?
2. Can you revalue identifiable intangible assets?
3. True/False: Internally generated goodwill may be recognised on the balance sheet.
4. True/False: Goodwill should be amortised.
5. True/False: Goodwill is subject to an annual impairment test.

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Critical perspective

- **Intangible asset standard archly conservative.**
- **Fails to require recognition of many internally generated intangible assets will reduce the value of balance sheets.**
- **Places a number of severe restrictions on the revaluation of intangible assets.**
- **Introduces subjectivity: assessments about whether goodwill has been 'impaired'.**

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