APPLY IAS 10 & 23 REPORTING EVENTS AFTER REPORTING PERIOD & RECOGNIZING BORROWING COSTS

- **IAS 10: REPORTING EVENTS AFTER REPORTING PERIOD**

1 INTRODUCTION

- Users' information needs
- Preparers should take account of all available information when preparing the annual report and financial statements

What it does:

- IAS 10 sets the rules when an entity should adjust its financial statements for ***events after the reporting period*** together with the necessary disclosures.
- It defines both ***adjusting and non-adjusting*** events.
- There are ***4 main types of material events*** after the reporting period:
  - ***Dividends*** declared in this period after the reporting period, but before approval of the financial statements;
  - ***Going concern*** assumption no longer applies after the reporting period;
  - Events that were ***unknown, or unclear***, at the reporting date;
  - Conditions arising ***after the reporting period***, not existing prior the end of the reporting period

- ***Event after the reporting period*** is favourable or unfavourable event that occurs between :
- The end of the reporting period and
- The date that the financial statements are authorised for issue.
- There are two types of events after the reporting period:
- Adjusting events
- Non-adjusting events.
- **Adjusting events**
- ***Adjusting event*** is the event that arose after the end of the reporting period, but provides further evidence of conditions that existed at the end of the reporting period.

- ***Accounting treatment:*** financial statements should be adjusted for adjusting events.

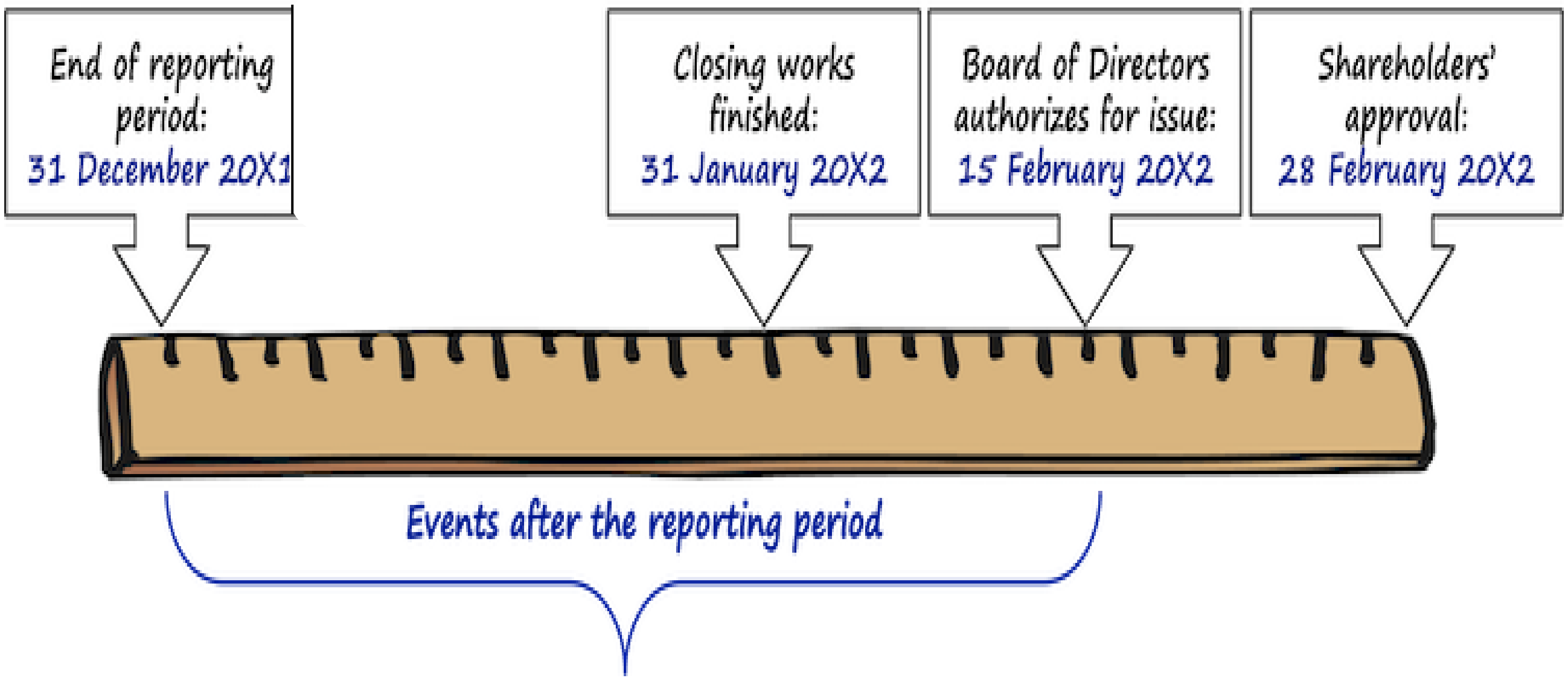
- ***Going concern***: If a management indicates after the end of the reporting period that it intends to liquidate the business or cease trading or there is no other realistic alternative, then the financial statements should NOT be prepared under going concern basis.

- ***Non-adjusting event*** is an event after the reporting period that indicates conditions arising after the end of the reporting period.

- ***Accounting treatment:*** do not adjust financial statements for non-adjusting events. The following disclosure shall be made:
  - The nature of the event, and
  - An estimate of its financial effect or a statement that such an estimate cannot be made.

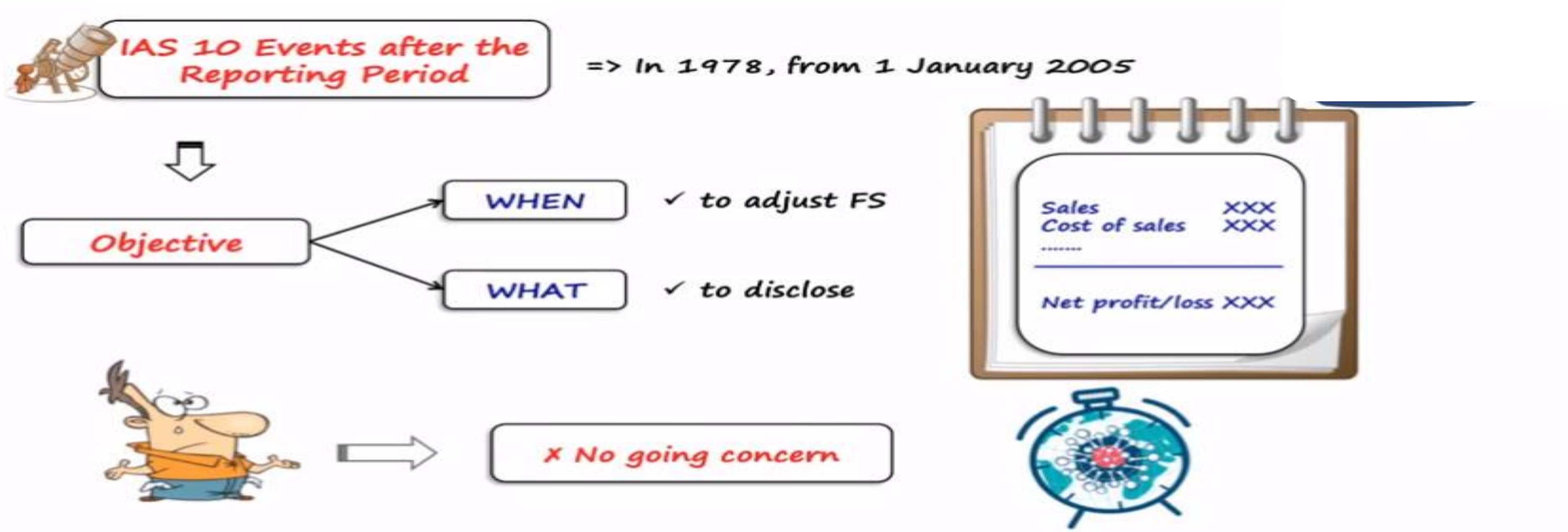
- ***Accounting for dividends:*** If an entity declares dividends to shareholders after the end of the reporting period, the entity shall not account for those dividends as for a liability at the reporting date.

- If dividends are declared after the end of the Reporting Period, but before the financial statements are approved for issue, the dividends are disclosed in the notes to the financial statements.


End of reporting period:
31 December 20X1
Closing works finished:
31 January 20X2
Board of Directors authorizes for issue:
15 February 20X2
Shareholders' approval:
28 February 20X2
Events after the reporting period

2 IAS 10 *EVENTS AFTER THE REPORTING PERIOD*

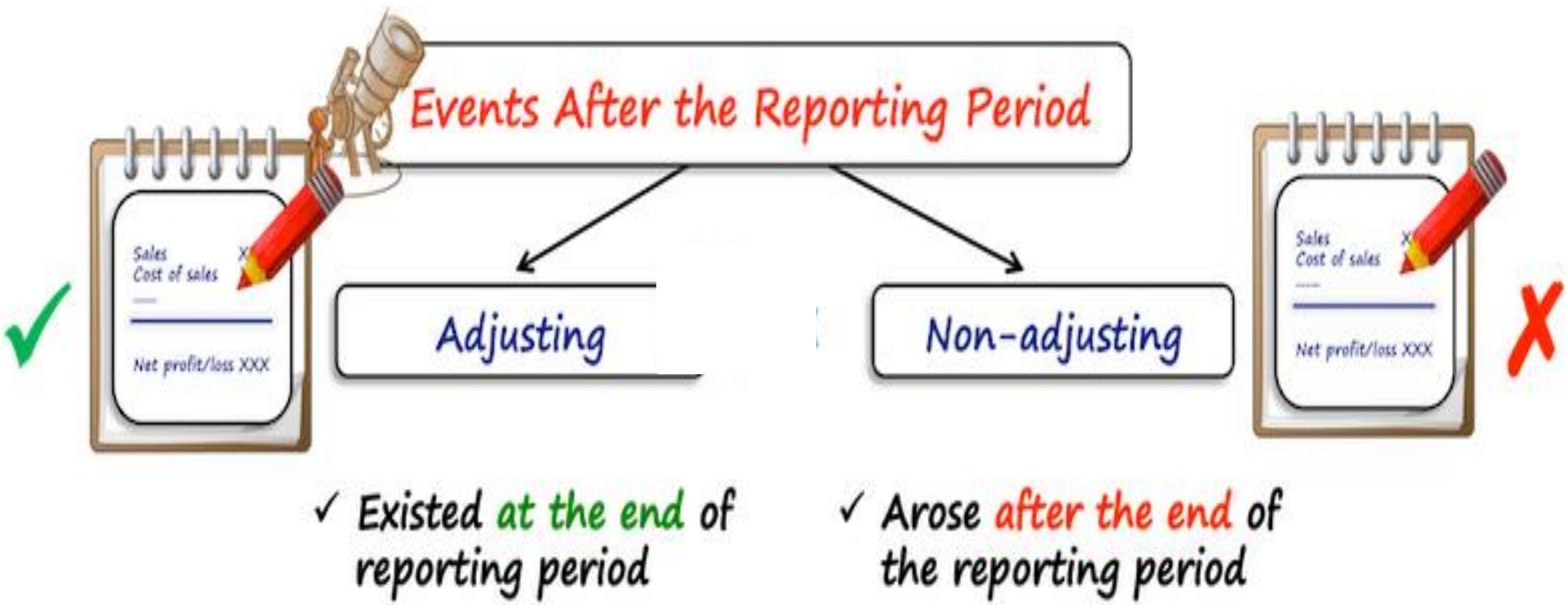
- Objective
  - to specify when an enterprise should adjust its financial statements for events occurring after the end of the reporting period
  - the disclosures that should be made about date of authorisation of financial statements for issue and about events occurring after the end of the reporting period



TYPES

Definition

- Those events, both favourable and non-favourable, which occur between the end of the reporting period and the date on which the financial statements are authorised for issue.



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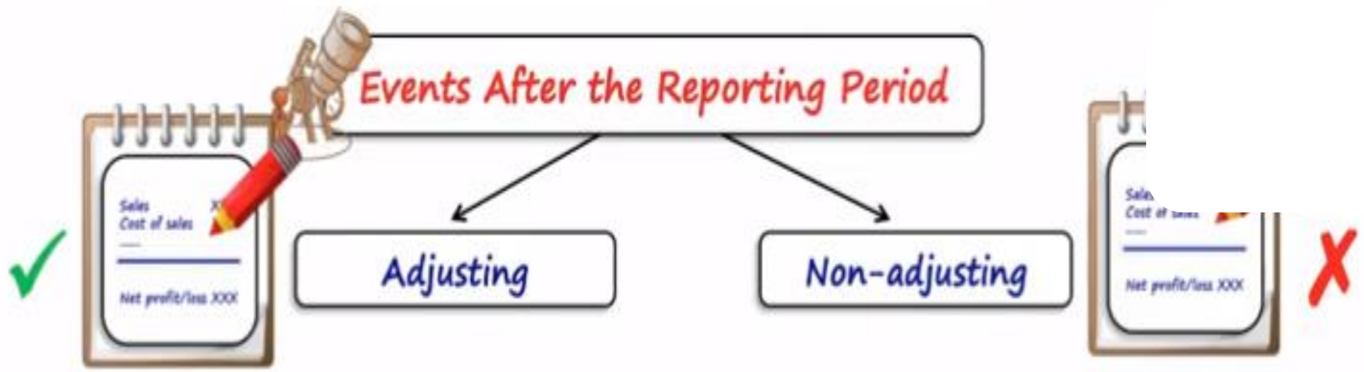
SUMMARY



	Adjusting	Non-adjusting
Conditions:	✓ Existed at the end of reporting period	✓ Arose after the end of the reporting period
What to do:	✓ Adjust the amounts in the FS to reflect those events	✓ Do not adjust ✓ Disclosures: nature, effect
Examples:	✓ Settlement of court case ✓ Bankruptcy of a client ✓ Fraud or errors	✓ Decline in FV of investments ✓ Natural disasters ✓ Dividends declared after end of r.p.

Types of event

- Adjusting events
  - Events after the reporting date and before the date of authorisation of the financial statements that provides evidence of conditions that ***existed at*** the reporting date
  - IAS 10 states that where there is a ***material*** adjusting event, the financial statements must be changed to reflect this event

- Non-adjusting events
  - Event after the reporting date and before date of authorisation of financial statements that is indicative of conditions that ***arose after*** the reporting date
  - By definition, ***no adjustment*** required to amounts recognised in the financial statements but possible disclosure

Adjusting events after the reporting period

- Subsequent determination of the purchase price or sale proceeds of assets purchased or sold before the end of the reporting period
- Valuation of a property which provides evidence of permanent diminution in value
- Receipt of information after the end of the reporting period which indicates that an asset was impaired at the end of the reporting period or that a previously recognised impairment was not adequate
- Sale of inventories after the end of the reporting period which gives evidence about their NRV at the end of the reporting period
- Renegotiation of amounts owing by debtors or insolvency of a debtor
- Bankruptcy of a debtor after the end of the reporting period that confirms that a loss existed at the end of the reporting period on trade receivables
- Amounts received or receivable in respect of insurance claims which were in the course of negotiation at the end of the reporting period
- Discovery of errors or frauds which show the financial statements were incorrect

Example 1: Adjusting events

Punjab Ltd is a producer and distributor of tea. The company's year ended is 31 December. The directors of Punjab are due to sign the company's financial statements for the year ended 31 December 2020 on 5 March 2021. The following information is available.

1. Flavoured tea is included in year end inventory at its original cost of €120,000. Audit work carried out in February 2021 indicated that the tea was sold for €100,000 in January 2021 due to a fall in demand for such products during 2020.

2. During 2020 there had been industrial unrest amongst Punjab's production workers following automation of one of the manufacturing processes. Management had sought to make 20% of the workforce redundant. In February 2021, following protracted negotiations it was agreed that 15% of the workforce would be made redundant at a cost of €400,000.

Example 1: Adjusting events

(Cont'd)

3. On 31 January 2021, €250,000 was paid to Trevor Baggins as compensation for his removal of Managing Director. Mr Baggins has been dismissed by the Chairman at the December 2020 Board Meeting as a result of a serious disagreement over marketing strategy for 2021.

4. It was discovered in January 2021 that a long serving employee had systematically stolen €250,000 over the previous four years. Material errors had thus been made in the financial statements over those years and there is now no chance of recovery.

Requirement

Explain briefly how each of the above transactions should be treated in the financial statements of Punjab for the year ended 31 December 2020.

Example 1: Adjusting events

Issue 1:

Inventory is valued at the lower of cost and net realisable value (IAS 2 *Inventories*). Demand fell during 2020 and the sale in January 2021 provides evidence of conditions that existed at the reporting date. Therefore it is an adjusting event.

Dr SPLOCI – P/L – Cost of goods gold	€20,000	
Cr SFP – Inventory		€20,000

Issue 2:

This is an adjusting event. The redundancy conditions existed at the reporting date and the final agreement merely settled the terms. Given its nature, it might be considered an exceptional item.

Dr SPLOCI – P/L – Redundancy costs	€400,000	
Cr SFP – Restructuring provision		€400,000

Example 1: Adjusting events

Issue 3:

The dismissal of Mr Baggins took effect before the end of 2020. Therefore the compensation payment is an adjusting event in the 2020 financial statements.

Dr SPLOCI – P/L – Termination costs	€250,000	
Cr SFP – Other payables		€250,000

Issue 4:

The discovery of errors/fraud that existed/ocurred prior to the end of the 2020 reporting period is an adjusting event.

Non-adjusting events after the reporting period

- ***Do not*** result in changes to the amounts recognised in the FS. They may, however, be of such materiality that their ***disclosure*** is required to ensure that the FS are not misleading.

- If material, disclose for each material category of non-adjusting event after the reporting date:

  - Nature of the event;
  - Estimate of the financial effect, or a statement that is not practicable to make such an estimate; and
  - Estimate of the financial effect should be disclosed before taking account of taxation; and the taxation implications should be explained where necessary for a proper understanding of the financial position.

Non-adjusting events after the reporting period

- Closing a significant part of the trading activities if not anticipated at the end of the reporting period
- Acquisition/disposal of subsidiary after the end of the reporting period
- Major purchases/disposals of assets after the end of the reporting period
- Fire after the end of the reporting period which results in the destruction of a major production plant
- Decline in the value of property and investments held as non current assets, if it can be demonstrated that the decline occurred after the end of the reporting period
- Decline in market value of investments between the end of the reporting period and the date when the financial statements are authorised for issue
- Announcing a plan to discontinue an operation
- Commencing major litigation arising solely out of events that occurred after the end of the reporting period

Example 2: Non-adjusting events

Pinewood Limited is a furniture manufacturing company. The company was informed on 1 February 2021 that one of its major customers, cushion Limited , had gone into liquidation. The liquidator indicated that no payments would be made to unsecured creditors. The amount owed by cushion Limited on 1 February 2021 amounted to €55,000, of which €30,000 related to goods invoiced on 10 December 2020 and €25,000 to goods invoiced on 15 January 2021.

Requirement

Explain how the above item would be dealt with in the financial statements of Pinewood Limited for the year ended 31 December 2020.

Example 2: Non-adjusting events

Solution

- As the liquidation occurred after the reporting date, it is dealt with in accordance with IAS 10
- The liquidation is an adjusting event
- The amount of the adjustment in the 2020 financial statements is limited to €30,000 (i.e. the amount outstanding at the reporting date)
- If the additional amount of €25,000 is deemed to be material, it should be disclosed by way of note

Example

DEF has a receivable towards major client amounting to TZS 500 as at 31 December 2021.

On 10 January 2022 there is a big fire in the client's premises and as a result, the client is not able to pay the full amount to DEF and DEF will suffer a loss of 50%.

How shall this transaction be reported in the financial statements?

Solution:

This is a non-adjusting event, because the credit loss arose as a result of fire occurring after the end of the reporting period. DEF needs to make appropriate disclosures in its financial statements.

Going concern issues arising after the end of the reporting period

- An entity ***should not*** prepare its financial statements on a going concern basis if management determines that after the reporting period either:
  - that it intends to liquidate the entity or to cease trading; or
  - that it has not realistic alternative but to do so.

Example: XYZ has a trade debtor that owes TZS 50 million on 31 December 2021.

On 21 January 2022, the debtor goes into liquidation. XYZ is informed that it will receive nothing from the liquidation.

XYZ is unable to raise funds to recover from this loss, and is certain to be liquidated.

How shall this situation be reflected in the financial statements for the year ended 31 December 2021?

Solution: The financial statements to 31 December 2021 should be produced on a liquidation basis, not a going-concern basis.

Proposed dividends

- To accrue dividends at the reporting date they must have been approved by shareholders at the AGM ***prior*** to the reporting date
- If the dividends are proposed by the directors before the reporting date but the AGM does not take place until after the reporting date then the dividend cannot be accrued, but must be disclosed in the notes to the financial statements
- Equity dividends declared after the end of the reporting period are ***not*** a liability as at the end of the reporting period. These dividends should be disclosed in a note to the financial statements as a contingent liability (IAS 37 – See Chapter 14)

Proposed dividends

Adjusting event → **Adjust financial statements**

Non-adjusting event → **Disclosure only**

Dividends proposed/declared after the end of the reporting period do not meet the definition of a liability at the end of the reporting period and should not be accrued in the FS

Dividends due from subsidiaries are not income in parent's individual accounts if declared after the end of the reporting period

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KLM has prepared its financial statements for the year ended 31 December 2021.

On 30 January 2022, KLM's directors declare dividends amounting to TZS 2 million.

How shall this transaction be reported in the financial statements for the year ended 31 December 2021?

Solution:

This is a non-adjusting event. KLM does not change the figures in its financial statements for the year 2021, but discloses the post-reporting-period dividends in the note on retained earnings.

15.3 DISCLOSURE

- In addition to the disclosures mentioned previously for non-adjusting events, the following must also be disclosed:
  - Date of authorisation of the financial statements
  - Who gave authorisation
  - If the owners or others have the power to amend the financial statements after issue, this must be disclosed

Lawsuit

ABC has been sued for the damages caused, but just before the year-end the lawyers believe that the chance of losing the case is remote and thus no provision has been created.

On 15 February, the court approved TZS 100 mil. damages against ABC.

Required: How should this event be recognized in the financial statements?

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Solution:

It depends on the date when the financial statements have been approved and authorized for an issue.

If it is after 15 February, then the event is adjusting, because the new information indicated that ABC was liable for the damages caused prior the end of the reporting period.

The journal entry is:

Debit P/L – Legal expenses for damages: TZS 100 mil.

Credit Provision: TZS 100 mil.

If the financial statements were authorized for an issue before 15 February, then by definition it is NOT the event after the reporting period and it out of scope of IAS 10.

Bad debts

DEF has a receivable towards major client amounting to TZS 5,000,000 as at 31 December 2021.

On 10 January 2022 there is a big fire in the client's premises and as a result, the client is not able to pay the full amount to DEF and DEF will suffer a loss of 50%.

How shall this transaction be reported in the financial statements?

Solution:

This is a non-adjusting event, because the credit loss arose as a result of fire occurring after the end of the reporting period. DEF needs to make appropriate disclosures in its financial statements.

IAS23: BORROWING COSTS

- Capital structure – debt vs. equity – arguments for and against
- Debt can be attractive
- Borrowing costs – an expense or a necessary cost in bringing a non-current asset to its present location and condition?
- When should capitalisation begin and end?

IAS 23 Borrowing Costs

International Accounting Standard 23

IAS 23 Borrowing Costs

- ✓ *Qualifying assets*
- ✓ *Capitalize vs. expense*
- ✓ *Capitalization rate*

Key definitions

- ***Borrowing costs*** are interest and other costs incurred by an entity in connection with the borrowing of funds

- ***Qualifying asset*** is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale (Note here that IAS 23 does not say it must necessarily be an item of a property, plant and equipment under IAS 16. It can also include some inventories or intangibles, too!)
  - . But what is a ***"substantial period of time"***?
  - Well, that's not defined in IAS 23, so here you need to apply some ***judgment.*** Normally, if an asset takes ***more than 1 year*** to be ready, then it would be qualifying

IAS 23 *BORROWING COSTS*

Objective:

- To prescribe the accounting treatment for borrowing costs

Accounting Treatment:

- IAS 23 requires the capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset when:
  - it is probable that the costs will result in future economic benefits and the costs can be reliably measured
  - the costs are directly attributable and they would have been avoided if the asset was not bought, constructed or produced

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What can we capitalize?

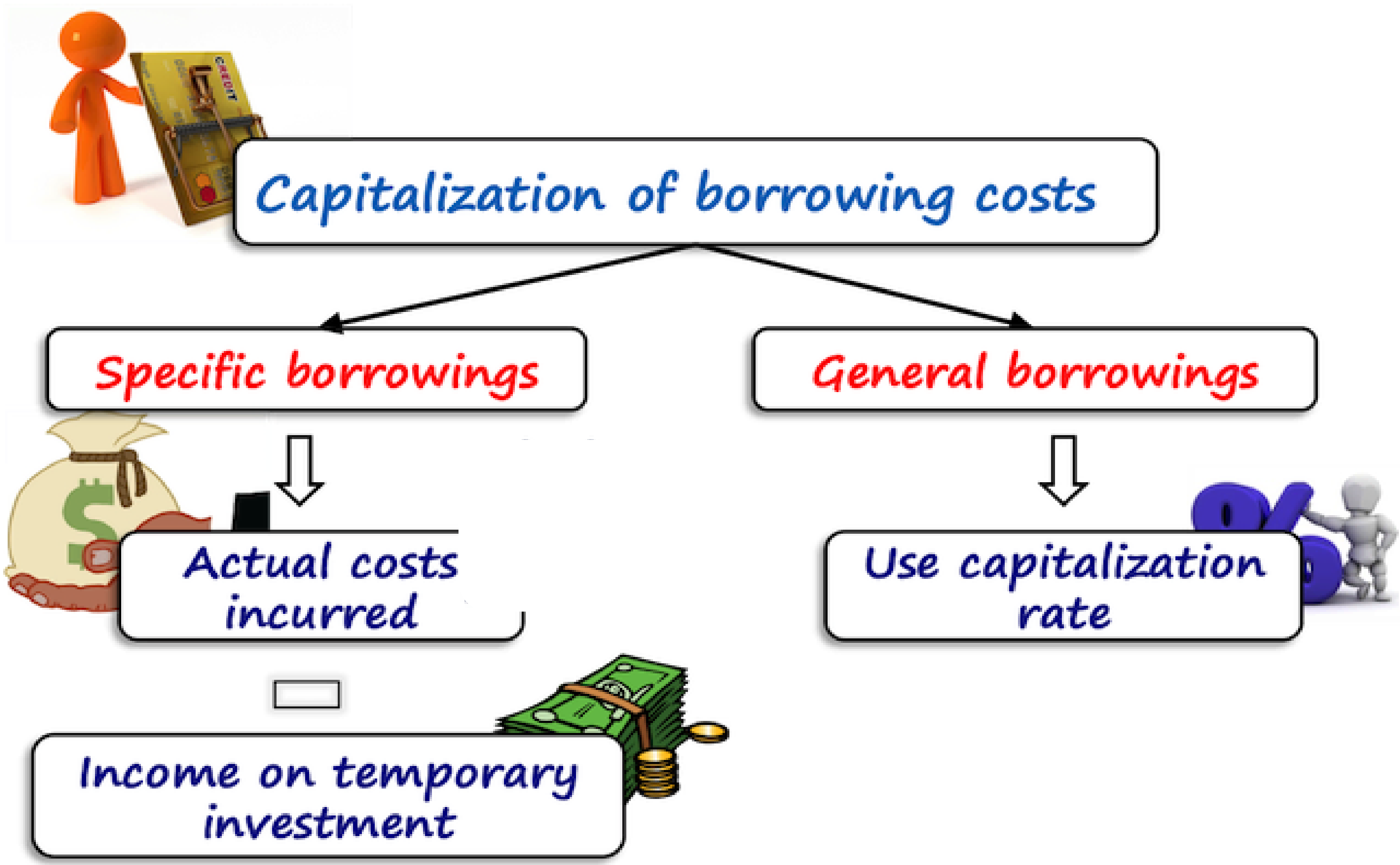
- IAS 23 specifically mentions 3 types of borrowing costs that can be capitalized:
  - Interest expenses (refer to the effective interest method under IFRS 9/IAS 39);
  - Finance charges on finance leases under IAS 17; and
  - Exchange differences on borrowings in foreign currencies, but only those representing the adjustment to interest costs.
- However, IAS 23 is pretty silent on some types of expenses and there are doubts whether they are borrowing costs or not, for example:
  - Interest cost on derivatives used to manage interest rate risk on borrowings;
  - Dividends payable on preference shares (or other types of shares classified as liabilities);
  - Gains or losses arising from early repayment of borrowings, etc.

Here again, we need to apply our knowledge from other IFRS standards and sometimes, make a judgment, too.

Period of capitalisation

- Capitalisation shall commence when expenditures for assets and borrowing costs are being incurred and activities are necessary to prepare the asset for its intended use or sale are in progress
- Capitalisation should cease when the asset is substantially complete, or when no work is being carried out for an extended period

How do you capitalize?



Specific borrowings

- If you borrowed some funds specifically for the acquisition of a qualifying asset, then the capitalization is easy:
- You simply capitalize the ***actual costs incurred less any income earned on the temporary investment*** of such borrowings.

Period of capitalisation

- Borrowing costs capitalised = actual costs less any investment income received from the temporary reinvestment of unutilised borrowings
- When funds borrowed generally and used to obtain a qualifying asset, amount to be capitalised is:

  Asset cost x capitalisation rate (weighted average)

- Total cost of a qualifying asset to be recognised cannot exceed its recoverable amount
- Borrowing costs capitalised in a period cannot exceed the amount incurred in that period

Example 1: Capitalisation of borrowing costs

On 1st May 2021, DEF took a loan of TZS 1,000,000 from a bank at the annual interest rate of 5%. The purpose of this loan was to finance a construction of a production hall.

The construction started on 1 June 2021. DEF temporarily invested TZS 800,000 borrowed money during the months of June and July 2021 at the rate of 2% p.a.

What borrowing cost can be capitalized in 2021? (Assume all interest was paid).

Answer:

Although the funds were withdrawn on 1st May, the capitalization can start only on 1st June 2021 when all criteria were met (the construction had not started until 1st June).

Calculation:

Interest expense: TZS1,000,000 x 5% x 7/12 = TZS 29,167
Note: this is very simplified calculation and if the loan is repayable in installments, then you need to take the real interest incurred (by the effective interest method).

Less investment income: TZS 800,000 x 2% x 2/12 = TZS 2,667

Total borrowing cost to capitalize in 2021: TZS 26,500

Just don't forget that the borrowing cost in May 2021 is expensed in profit or loss, as the capitalization criteria were not met in that period.

General borrowings

- Now, there's more trouble with capitalizing general borrowings, as you need to prepare a bit more calculations.
- General borrowings are those funds that are obtained for various purposes and they are used (apart from these other purposes) also for the acquisition of a qualifying asset.
- In this case, you need to apply so-called ***capitalization rate*** to the borrowing funds on that asset, calculated as the ***weighted average of the borrowing costs applicable to general pool.***
- To illustrate it, let me give you an example about capitalizing borrowing costs on general borrowings.

Example 2:

ATCL had the following loans in place at the beginning and end of 2021:

Description	1 January 2021	31 December 2021
Bank loan, 6 % p.a.	-	200,000
Bank loan, 8 % p.a.	130,000	130,000
Debenture stock, 5.5% p.a.	50,000	50,000

The bank loan at 6% p.a. was taken in July 2021 to finance the construction of a new production hall (construction began on 1 March 2021).

The bank loan at 8% p.a. and debenture stock were taken for no specific purpose and ATCL used them to finance general spending and the construction of a new machinery.

ATCL used TZS 60 000 for the construction of the machinery on 1 February 2021 and TZS 25 000 on 1 September 2021.

What borrowing cost should be capitalized for the new machinery?

Answer:

- You ignore bank loan at 6% p.a., because it is a specific borrowing for another asset.
- Only general borrowings relate to the financing of the new machinery and therefore, we need to calculate the capitalization rate:
  - ***Weighted average rate*** = (8% x 130 000 /(130 000+50 000)) + (5.5% x 50 000/(130 000+50 000)) = 5.78%+ 1.53% = ***7.31%***
  - ***Borrowing costs for the new machinery in 2021*** = TZS 60 000 x 7.31% x 11/12 + TZS 25 000 x 7.31% x 4/12 = TZS 4 021 + TZS 609 = ***TZS 4 630***

Example 3: Capitalisation of borrowing costs

On 1 January 2020, X began to construct a supermarket. It purchased a leasehold interest in the site for TZS 25 million. The construction of the building cost TZS 9 million and the fixtures and fittings cost TZS 6 million. The construction of the supermarket was completed on 30 September 2020 and it was available for use from 1 January 2021.

X borrowed TZS 40 million on 1 January 2020 in order to finance this project. The loan carried interest at 10% per annum. It was repaid on 30 June 2021.

Requirement

Calculate the total amount to be included in property, plant and equipment in respect of the development at 31 December 2020.

Example 4: Capitalisation of borrowing costs

Solution:

The total amount to be included in property, plant and equipment at 31 December 2020 is:

	TZS
Lease	25m
Building	9m
Fixtures and Fittings	6m
Interest (TZS 40m x 10% x 9/12)	3m
Carrying value	43m

Only 9 months' interest can be capitalised. IAS 23 states that capitalisation must cease when substantially all the activities necessary to prepare the assets for its intended use or sale are complete. No depreciation is charged, because the supermarket was not available for use until 1 January 2021.

Disclosures

- Amount of borrowing costs capitalised during the period
- Capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation

CHALLENGING QUESTION 2

In January 2020, Yellow commenced a programme to extend and modernise the company's manufacturing facilities. The programme cost TZS1,000,000 and Yellow financed the work through a mixture of general and specific debt. The directors' estimate was that 50% of the programme was financed by general debt and 50% by specific debt. Yellow's current general borrowing rate is 10% per annum while the specific debt carries an interest rate of 15% per annum. The programme was completed in December 2020.

Requirement

Explain how Yellow should account for the borrowing costs in the financial statements for the year ended 31 December 2020.

CHALLENGING QUESTION 2 – Suggested solution

This will be added to the capital cost of the work and depreciated in accordance with IAS 16 *Property, Plant and Equipment*.

Working	€
TZS1,000,000 x 50% x 10%	50,000
TZS1,000,000 x 50% x 15%	75,000
	125,000

The hottest questions in capitalizing borrowing cost

- After we know the basics, let me give you my opinion on 3 the most common and often questions in relation to capitalizing borrowing cost.
- In real a practice you can receive these questions quite often, so let us shed some light there.

Question #1: Can you capitalize interest cost in the cost of inventories?

- It depends.
- In most cases, inventories do not take a substantial period to get ready and in this case no, you cannot capitalize.
- But here, there are some examples of inventories that can take a substantial period to complete:
  - Wine, cheese or whiskey that matures in bottle or cask for a long period of time;
  - Large items of equipment, such as aircraft, ships etc.
- In this case, you can capitalize borrowing cost, but ***it's up to you if you will or won't.***
- While you have no choice for PPE (you have to capitalize), ***you have a choice for inventories***: either you capitalize, or expense in profit or loss.

Question #2: Can you capitalize foreign exchange loss on specifically borrowed money in a foreign currency?

- No, you cannot do it fully.
- Yes, IAS 23 says that exchange differences on foreign currency borrowings are a borrowing cost to the extent that they are regarded as an adjustment of interest cost.
- Simply speaking – you can capitalize the difference between the interest on the foreign currency loan and the hypothetical interest expense in your own (functional currency), because that’s regarded as borrowing cost.
- The rest must be expensed in profit or loss.

Question #3: Can you capitalize interest cost on intercompany loan for qualifying assets?

- Yes, in the separate financial statements of the borrowing company.
- However, be a bit careful about the consolidated financial statements, because based on the intercompany relationship (subsidiary or associate?), the intercompany loan might be eliminated.
- Also, let me point out one more issue in relation to intercompany loans: often, they are provided ***interest-free.***
- Under IFRS 9, you should recognize almost all financial instruments ***at their fair value*** (sometimes plus transaction cost) and if a subsidiary gets an interest-free loan from a parent, it's nominal amount is not at fair value.
- Therefore, a subsidiary needs to ***set the fair value of the loan*** received using the market interest rates and ***book the difference between the loan's fair value and the cash received in profit or loss*** (based on the substance of a transaction).
- Then, interest expense calculated by the effective interest method is capitalized.
- I know, this might sound odd: the loan is interest-free, but you still need to capitalize some borrowing cost on it. Careful!