International Financial Accounting

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Income statement

Session 3: Income statement

Introduction to income statement

Revenue (IFRS 15)

Share-based payments (IFRS 2)

Introduction to income statement

Recap: English terminology

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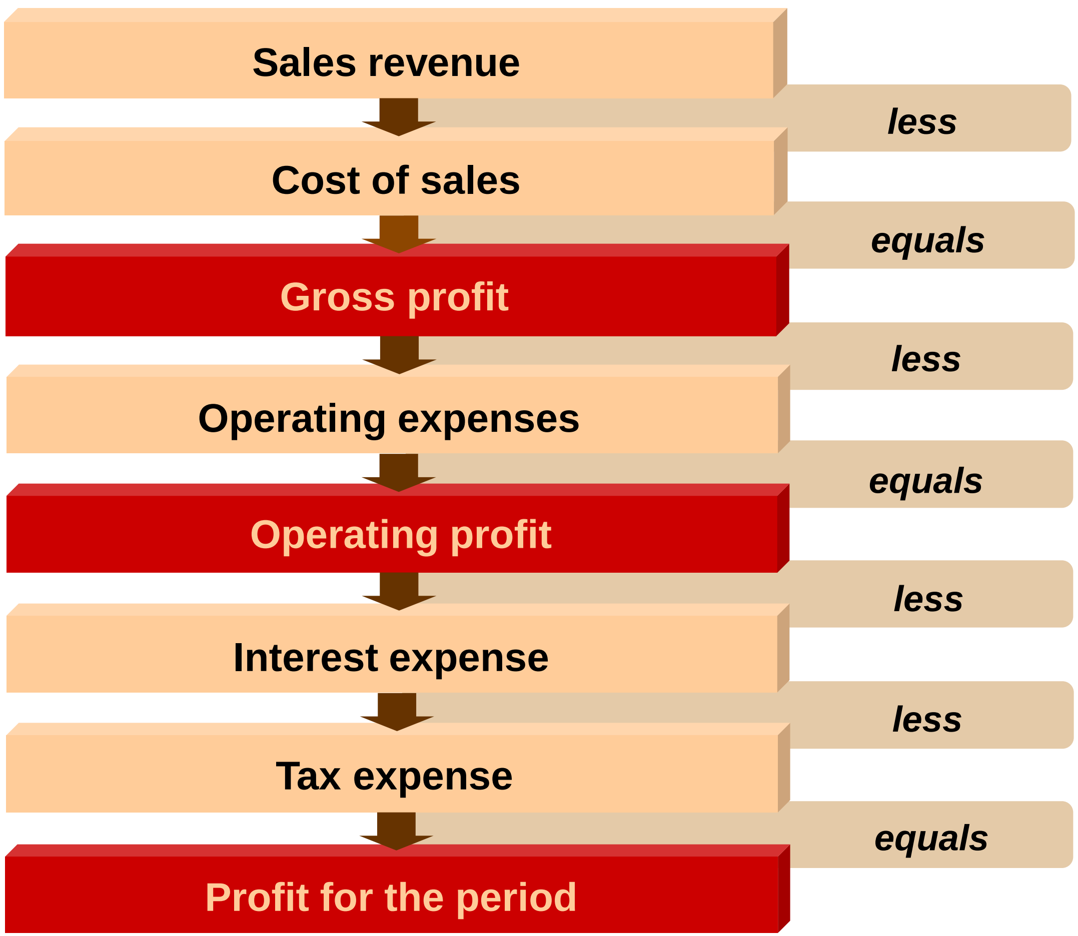
The Income Statement

Revenues
- Sales Revenue
- Fee Revenue
- Interest Revenue
- Rent Revenue

Expenses
- Cost of Goods Sold
- Wages Expense
- Rent Expense
- Interest Expense
- Depreciation Expense
- Advertising Expense
- Insurance Expense
- Repair Expense
- Income Tax Expense

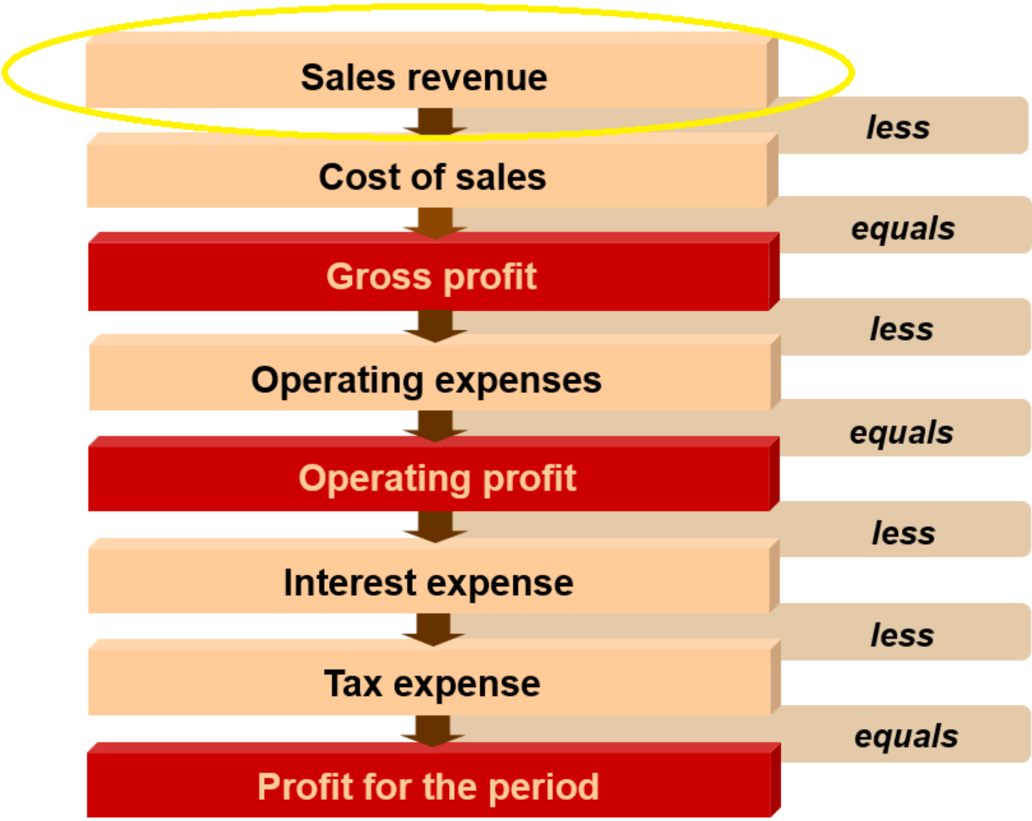
AutoDesk & Ayden

Layout of income statement



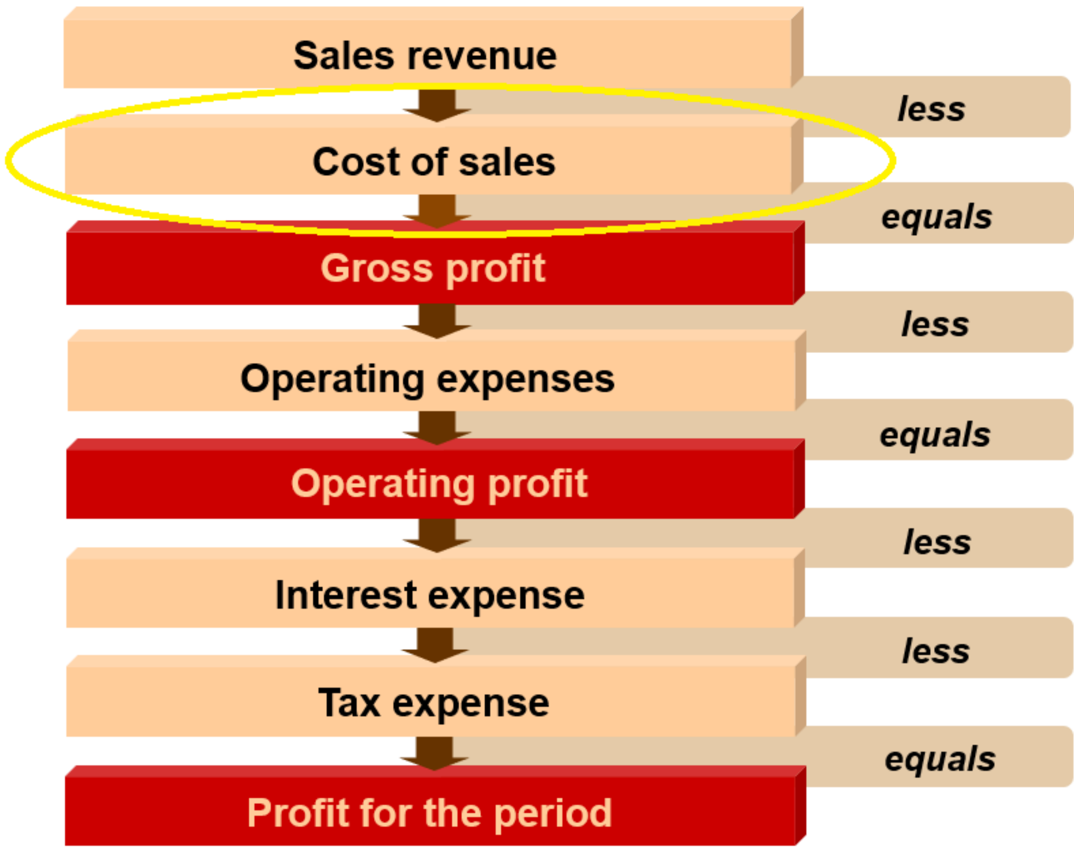
Revenue

(the very important 1st line of income statement)

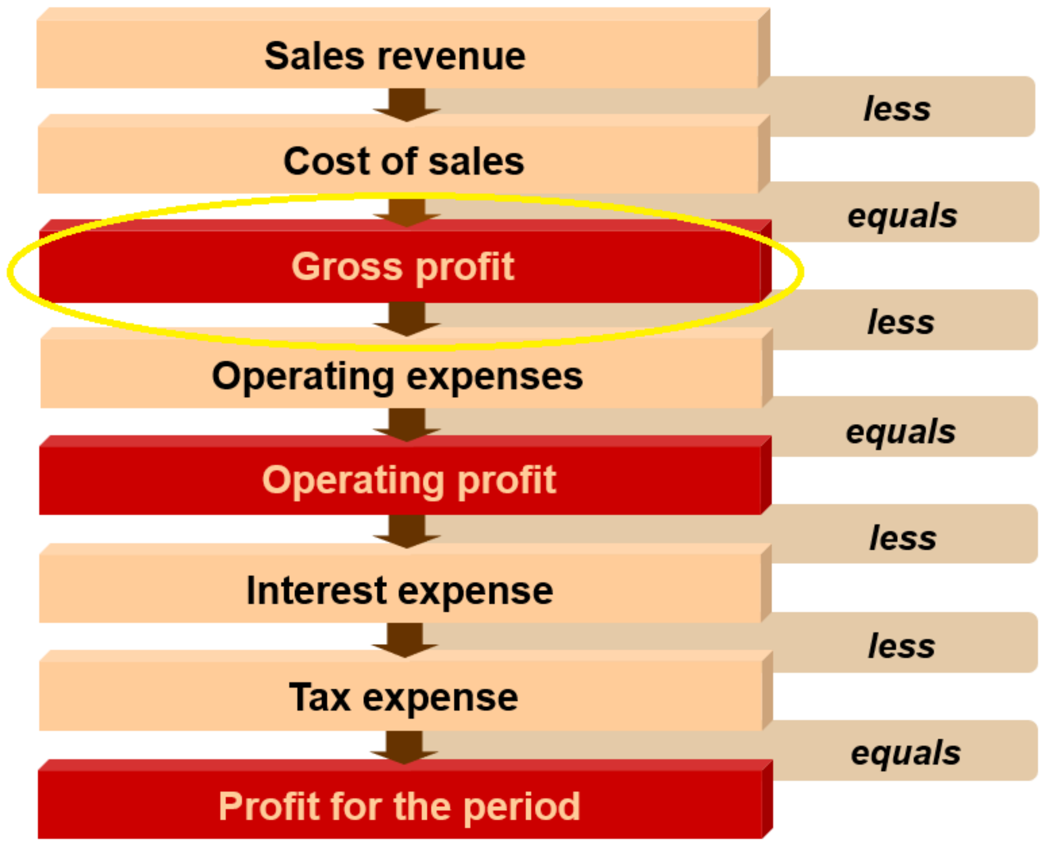


Cost of sales

(2nd line of the income statement)



Gross profit



Operating expenses

Operating profit

Sales revenue

less

Cost of sales

equals

Gross profit

less

Operating expenses

equals

Operating profit

less

Interest expense

less

Tax expense

equals

Profit for the period

Tax expense

Sales revenue

less

Cost of sales

equals

Gross profit

less

Operating expenses

equals

Operating profit

less

Interest expense

less

Tax expense

equals

Profit for the period

Interest expense

Sales revenue

less

Cost of sales

equals

Gross profit

less

Operating expenses

equals

Operating profit

less

Interest expense

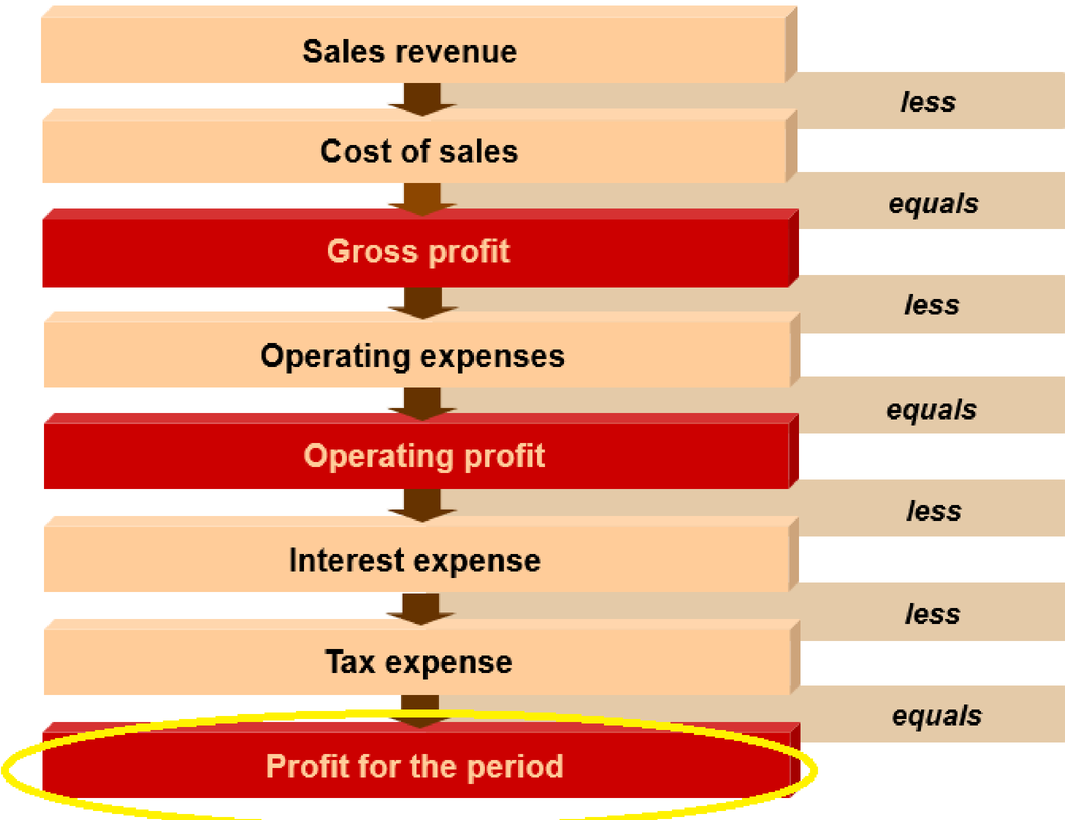
less

Tax expense

equals

Profit for the period

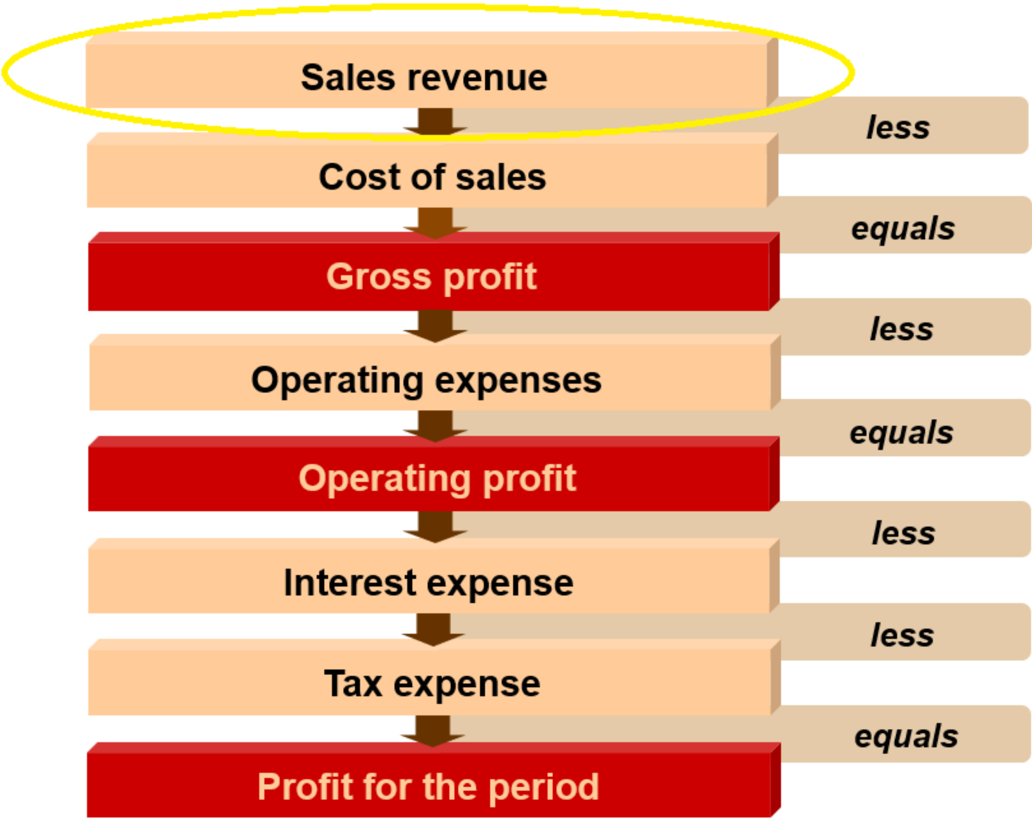
Net profit / “residual profit”



Revenue (IFRS 15)

Revenue

(the very important 1st line of income statement)



Revenue & IFRS 15

IFRS 15: Establishes principles for reporting about nature, amount, timing & uncertainty of revenue & cash flows arising from contracts with customers

Standard was issued in May 2014 and became effective for all annual periods beginning on or after 1 Jan 2018 (earlier application permitted)

Reasons for issuing IFRS 15

Revenue is an important number for assessing financial performance

Sales revenue usually single largest figure reported in financial statements

Investors place significant weight on revenue when evaluating past performance & future prospects

- Trend & growth rate in historical sales revenue drives many valuation models (e.g. free cash flow models)

Revenue recognition is also an area of financial reporting that has historically been susceptible to misstatement / fraud:

- Revenue being recorded that is dependent on uncertain future events
- Revenue being recorded before delivery completed
- Contract revenue being recognised before services are performed
- Fictitious sales agreements & documentation

Overview

IFRS 15 provides a single, comprehensive 5-step model to account for revenue

Core Principles:

Recognition: the entity shall recognise revenue to depict the transfer of control of goods or services to customers

Measurement: revenue shall be measured at the amount the entity expects to be entitled to in exchange for the goods or services transferred

- IFRS 15 requires distinct goods or services to be accounted for separately.

5 step process to recognise revenue

Step 1: Identify the contract(s) with the customer [RECOGNITION]

'Contract' is an agreement between 2 or more parties that creates enforceable rights & obligations (in a legal sense)

Parties have approved contract & are committed to perform respective obligations → Can be oral, written or implied by business practices

Can identify each party's rights regarding goods/services to be transferred

Can identify payment terms for goods/services to be transferred

Contract has commercial substance

It is probable the entity will collect consideration which it is entitled to in exchange of G/S

5 step process to recognise revenue

Step 2: Identify contract 'performance obligations' [RECOGNITION]

Part of contract is a promise to provide G/S

If G/S are DISTINCT, the promise is a 'performance obligation' & should be accounted for separately

- G/S are DISTINCT if:
  - Customer can benefit from G/S on its own
  - Promise to provide those G/S is separately identifiable from other promises in the contract

5 step process to recognise revenue

Step 3: Determine the 'Transaction Price' [MEASUREMENT]

- 'Transaction Price': amount of consideration the entity expects to be entitled to in exchange for transferring promised goods/services (i.e. total contract consideration)

- TP should be adjusted for the time value of money.

- If the TP has a variable component: variable part only included in the TP if highly probable a significant reversal of revenue will not occur when the uncertainty is resolved

5 step process to recognise revenue

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Step 4: Allocate 'Transaction Price' to 'Performance Obligations' in the contract [MEASUREMENT]

Normally done based on the relative stand-alone selling price of each distinct G/S promised in the contract

If the selling price is not observable – estimate it !

5 step process to recognise revenue

Step 5: Recognise revenue when the entity satisfies a 'Performance Obligation' [RECOGNITION]

- Entity satisfies a performance obligation by transferring control of G/S to a customer (i.e. when customer obtains control of G/S)

- Amount of revenue recognised is the amount allocated to the satisfied performance obligation

- A performance obligation may be satisfied:

  - AT a point in time – typically with promised goods OR
  - OVER time – typically with promised services

➢If recognised OVER time: entity recognises the revenue by selecting an appropriate method for measuring progress toward the complete satisfaction of the performance obligation.

Question

When does 'control' of goods pass from buyer to seller?

A sandwich ?

A ship on the sea ?

Step 5: Let's think about "performance" !

Goods & Services are an asset (even if only momentarily) when they are received & used

'Control': refers to the ability to direct the use of and obtain substantially all the benefits of the assets & to be able to protect/prevent the use of others in relation to those benefits

- Factors that MAY indicate a transfer of control:
    1. Point at which the entity is entitled to payment
    2. Legal title transfers
    3. Transfer of physical possession of an asset except for under consignment (where entity maintains control but not physical possession)
    4. Transfer of risks & rewards of ownership
    5. Customer has accepted the asset

Consignment Arrangements

When an entity delivers goods to another entity for sale to end customers, the entity should evaluate whether the other party has obtained CONTROL of the goods

- If the other party has not obtained control of the goods:
  - Goods held in a consignment arrangement & should **NOT** recognise revenue upon delivery
  - Revenue should only be recognised when control is transferred to the customer

- Indicators of a '**consignment arrangement**':
  - Product controlled by entity until a specified event occurs (e.g. the final sale of the goods to the end customer) or until a specified period expires
  - The entity is able to require the return of the goods or transfer the goods to a third party
  - The dealer does not have an unconditional obligation to pay for the product (although it may be required to pay a deposit)

Warranties

Warranties are frequently included in arrangements to sell G/S whether explicitly stated or implied by the past business practices

•2 types of warranty that should be accounted for differently:

(1) Service-type warranties and

(2) Assurance type warranties

1. Service-type warranty

Warranties that provide an additional service to the customer in addition to the assurance that the G/S is as specified in the contract

Indicators:

- Customer has option to purchase warranty separately
- Warranty provides a service beyond fixing defects which exist at time of sale

A service-type warranty is a distinct service and a separate performance obligation, therefore:

- Using the estimated stand-alone selling price of the warranty, the entity must allocate a portion of the transaction price to the warranty
- The allocated transaction price is recognised as revenue over the period that the warranty service is provided

(2) Assurance-type warranty

Warranties that promise customer that the delivered G/S is as specified in the contract

An assurance-type warranty does not provide an additional G/S to the customer

An assurance-type warranty is **not** a separate performance obligation - it is effectively a guarantee of quality

Assurance-type warranties are accounted for as warranty obligations under IAS 37 (Provisions, Contingent Liabilities & Contingent Assets)

Onerous Contracts

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An onerous contract is where the unavoidable costs of meeting the obligations of a contract, exceed the economic benefits expected to be received under it

Accounted for under IAS 37 (Provisions, Contingent Liabilities & Contingent Assets)

- Recognise a liability for expected losses on contract

Quiz

XCalc Ltd is a retailer which sells scientific calculators to schools

On the **21st December 2020**, XCalc receives a written order from a school for scientific calculators with a total retail value of €20,000

The cost of the inventory of calculators necessary to fulfil the order is €15,000 to XCalc

Due to Christmas break, calculators not delivered until **3rd January 2021**

The school paid for the order on **4th January 2021**

How would the above sale be reflected in financial statements of Xcalc for financial year ended 31st December 2020?

Answer

Share-based payments (IFRS 2)

Equity Settled Share-Based Payment

'Share based payment' transaction occurs when the entity receives goods or services in return for:

1. Equity instruments <u>OR</u>
2. Incurring a liability

We only focus on one type of share-based payment → Equity settled share-based payment:

- company issues own shares in exchange for goods and services

Scope of IFRS2

Concept of 'share-based payment' is broader than employee share options

IFRS 2 includes the issuance of share, or rights to shares, in exchange for goods and services

E.g.

- Share appreciation rights
- Employee share purchase plans
- Issuance of shares (or rights to shares) may depend on market or non-market related conditions

Equity Settled Share-Based Payments

Entity receives goods or services in exchange for its own equity instruments (including shares or share options)

- e.g. share option schemes offered to company employees

Typically schemes provide employees with the option of buying shares in the future at a pre-specified price

Goods + services received are measured at their fair value & recorded as an asset or expense

- There is a corresponding increase in equity

Equity Settled Share-Based Payments

There are 3 important dates:

1. **Date of grant** – date at which employees are granted the option at a future point in time.

- e.g. company on 1 Jan 2021 grants options to its directors to buy shares at €1.50 per share in the future
- 1 Jan 2021 is the date of grant of the options

2. **Vesting date** – this is the date on which director/employee qualifies for the option

- e.g. the option agreement on 1 Jan 2021 might stipulate that directors have to complete 3 years of service (dating from 1/1/2021)
- The vesting date of options would be 1/1/2024

3. **Exercise date** – this is the date that the directors/employees exercise their rights under the option agreement to purchase the shares

Equity Settled Share-Based Payments

Accounting treatment for 'equity settled share-based payments' is controversial topic !

Alves (2010) details the different arguments on whether or not ESSBP should be treated as an expense

Why shouldn't share options be treated as an expense?

- Does not meet the definition of an expense

CFW definition "expense": expenses are decreases in assets, or increases in liabilities that result in **decreases** in equity other than those relating to distributions to holders of equity claims

- Share options considered to be a capital transaction

- The potential dilution of share options already reflected in the diluted EPS figure

- The cost of share options cannot be estimated reliably

- Expensing share options will damage young companies
  - Deteriorate their income statements
  - Make it difficult to raise money
  - Economic consequences for early/growth start-ups

Why should share options be treated as an expense?

Disclosure is not a substitute for recognition

Cost of share options can be measured reliably

Expensing share options will not significantly damage young companies

- Investors comfortable with practice

IASB & IFRS 2 Position

Share options should be expensed

Share options regarded as payment in return for services provided by employees

Cost of providing share options is expensed over the vesting period

Thereby, matching cost incurred with the benefits derived from the employee's labour

Cost should be measured at the fair value of shares/share options at the date of grant of the options

Example 1

On 1 January 2021, M plc issued share options, giving each of four executives the right to purchase 25,000 shares at 25 cents a share. The value of the shares on 1 January 2021 was €1. A condition of the agreement was that the executive would complete three years of service from 1 January 2021. The nominal value of the company's shares was 10 cents. It should be assumed that the fair value of each share option on 1 January 2021 equals 75 cents.

The company's share price on subsequent dates:

1 January 2022 - €1.50

1 January 2023 - €2

1 January 2024 - €3

REQUIRED: Outline how the share options should be accounted for by M plc.

Example 1 Solution

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What if share options lapse during the vesting period?

Overall effect of IFRS 2 is to expense the fair value (at grant date) of share options **that vest**

See Example 2

Example 2 Solution

If one of the executives in Example 1 were to leave on 1 Jan 2022, and therefore lose his/her share option rights, the following journals would be required:

Example 2 Solution …cont'd

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What determines the fair value of the option at grant date?

IFRS 2 requires the fair value of equity instruments granted to be based on market prices, if possible

Terms + conditions of equity instruments should be taken into account when determining fair value

If market prices are not available, fair value should be estimated using a valuation technique to estimate price of equity instrument

IFRS 2 Questions

tbs Business School

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