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IFRS for SMEs: accounting for transactions with owners in their capacity as owners

Tbilisi

October 2019

Technical session for Georgian IFRS for SMEs trainers

Disclaimer and applicable version of the IFRS for SMEs

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» Unless specified otherwise, the accounting requirements that are the subject matter of this presentation are the International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs) as issued by the International Accounting Standards Board (IASB) that are applicable for annual period beginning on or after 1 January 2019.

Objectives of this session

» Understand how in the Georgian context to account for transactions with owners in their capacity as owners in accordance with the IFRS for SMEs. In particular, understand the accounting, in accordance with Section 22 *Liabilities and Equity* for:
  - » owners contributing resources to an SME
  - » an SME distributing assets to its owners (ie dividends)
  - » an SME repurchases its own shares from an owner (including treasury shares)
  - » the controlling shareholder purchases SME's shares from a non-controlling interests

Accounting for owners contributing resources to an SME

Classification at initial recognition of an instrument issued

Generally classify as a financial liability unless SME has unconditional right to avoid delivering cash or another financial asset to settle obligation.

- Exceptions (ie classified as equity): instruments that **represent the residual interest in the net assets** of the entity (ie specified puttable instruments that entitle the holder to a pro rata share of net assets on liquidation and subordinated instruments payable only on liquidation if they impose an obligation to deliver a pro rata share of the net assets of the entity)
  - Exceptions from exception (ie classified as financial liabilities): if pro rata distribution payable on liquidation, but amount is subject to a maximum ceiling or SME is obliged to make payments before liquidation – such as mandatory dividend).

Classification at initial recognition of an instrument issued test your understanding

At initial recognition how must SME classify each of the following? Choose one or more of: 1) equity; 2) financial liability; or 3) part equity and part financial liability. On 01/01/2019 in exchange for the 1 million GEL received for each instrument below, SME promises:

A. to redeem the debentures on 31/12/2021 by paying 1.331 million GEL.
B. to redeem the preference shares on 31/12/2021 by paying 1.331 million GEL.
C. to repay interest-free loan from Shareholder whensoever Shareholder so demands. Shareholder does not intend to require SME to repay the loan.
D. to, at the option of Holder to be exercised on 31/12/2021, redeem the instrument by either: (i) paying 1.2 million GEL; or (ii) delivering 100,000 SME shares to Holder.

Measurement at initial recognition
equity instruments

- At initial recognition equity instruments issued are measured:
  - at fair value of cash or other resources received (receivable)
  - net of transaction costs (ie transactions cost are not an expense)
  - on a present value basis if payment deferred and time value of money is material

Measurement at initial recognition
compound financial instruments

- Must **account separately** for financial liability component and equity component (conversion right).
  - First measure the **financial liability component**: discount the contractual cash flows using the discount rate that would apply to pure debt with the same contractual cash flows.
  - **Equity component** is the residual (ie cash received less financial liability as measured above).

Measurement at initial recognition
example: compound financial instruments

On 01/01/2019 in exchange for the 1 million GEL received for each instrument below, SME promises:

» to redeem **Instrument A** on 31/12/2021 by paying 1.331 million GEL.

» to, at the option of the holder of **Instrument B,** to be exercised on 31/12/2021, redeem Instrument B by either: (i) paying 1.2 million GEL; or (ii) delivering 100,000 SME shares to Holder.

How must SME account for Instrument A and Instrument B at their initial recognition on 01/01/2019?

Accounting for the distribution of an SMEs resources to its owners

Distributions to owners

» In **economics**, which of the following are dividends declared? Choose one of:

1) expense and increase in liability;
2) reduction from equity and increase in liability; or
3) no economics until dividend is paid.

» What accounting does the **IFRS for SMEs** specify for distributions to owners in their capacity as owners (sometimes called dividend)?

Distributions to owners example 1

» **15/01/2020** SME declares 1 million GEL cash dividend 'out of profit for 2019'.

» **How must Entity account for the dividend in its 31/12/2019 annual financial statements?** Choose one of:

1) ↑expense GEL 1 million and ↑liability GEL 1 million;
2) ↓equity GEL 1 million and ↑liability GEL 1 million; or
3) do no accounting for the dividend (ie consider disclosure only).

Distributions to owners
example 2

» **31/12/2019** SME declares 1 million GEL cash dividend 'out of profit for 2019'.

» **How must SME account for the dividend in its 31/12/2019 financial statements?** Choose one of:

1) ↑expense GEL 1 million and ↑liability (shareholders for dividend) GEL 1 million;
2) ↓equity GEL 1 million and ↑liability (shareholders for dividend) GEL 1 million; or
3) do no accounting for the dividend (ie consider disclosure only).

Distributions to owners
Example 2 (continued)

» **15/01/2020** SME distributes (ie pays) the 1 million GEL cash dividend it declared on 31/12/2019.

» **How must SME account for the distribution in its 31/12/2020 annual financial statements?** Choose one of:

1) ↓asset (cash) GEL 1 million and ↓liability (shareholders for dividend) GEL 1 million;
2) ↓asset (cash) GEL 1 million and ↓equity (retained earnings) GEL 1 million;
3) ↓asset (cash) by GEL 1 million and ↑expense GEL 1 million; or
4) do no accounting for the dividend (ie consider disclosure only).

Non-cash distributions to owners

» **IFRS for SMEs accounting:** non-cash distributions are measured at the **fair value** of assets distributed. Exceptions to measure at the carrying amount of the asset distributed:

  » undue cost or effort exemption

  » if the assets are ultimately controlled by the same parties before and after distribution

Non-cash distributions to owners example

31/12/2019 SME holds a 1% equity interest in ListedCompany in the form of 1 million ListedCompany ordinary shares.

  » Carrying amount = fair value = GEL 1 million (ie GEL 1 per ListedCompany share).

01/01/2020 SME declares as a dividend, and distributes to its equity holders, the 1 million ListedCompany shares.

How must SME account for the distribution on 01/01/2020? Choose one of:

1) ↓asset (ListedCompany shares) GEL 1 million and ↓liability (shareholders for dividend) GEL 1 million;
2) ↓asset (ListedCompany shares) GEL 1 million and ↓equity (retained earnings) GEL 1 million;
3) ↓asset (ListedCompany shares) GEL 1 million and ↑expense GEL 1 million; or
4) do no accounting for the dividend (ie consider disclosure only).

Accounting for an SME's repurchase of its own shares from an owner (treasury shares)

Treasury shares economics and accounting

Treasury shares are equity instruments that an SME (entity or group) hold(s) in itself.

» **Question 1:** **What is the economics of a company buying is own shares (treasury shares)?**

» **Question 2:** **Which element of the statement of financial position are treasury shares?** Choose one of: 1) asset; 2) liability; or 3) equity.

Overview of **IFRS for SMEs accounting** for treasury shares (paragraph 22.16):

- » the fair value of consideration given to acquire treasury shares is deducted from equity
- » gain or loss on purchase/sale of treasury shares recognised directly in equity

» **Question 3:** **Which type of requirement is the accounting specified for treasury shares?** Choose one of: 1) a principle; 2) a notion; or 3) a rule.

Buying treasury shares example: economics and accounting

Transaction 1: on 01/01/2016 Company A pays GEL 1,500 (fair value) to buy 20% of its issued ordinary shares in a deep and liquid market.

» **Economics:** **what is the economics of transaction 1?**

» **IFRS for SMEs accounting:** **how must Company A account for transaction 1?**

Selling treasury shares example (continued): economics and accounting

Transaction 2: on 01/01/2019 Company A receives GEL 3,000 (fair value) from selling all of its treasury shares (ie 20% of its issued ordinary shares) in a deep and liquid market.

» **Economics:** **what is the economics of transaction 2?**

» **IFRS for SMEs accounting:** **how must Company A account for transaction 2?**

Mini-case study: the IFRS for SMEs

- **01/01/2019:** A and B each invest 100 000 USD (= 200,000 GEL each at 01/01/2019 spot exchange rate of 2 GEL : 1 USD) to form SME's (a company) share capital (= 'plain vanilla' ordinary shares).
- SME's functional currency is GEL.

- **Economics:** **what is the economics of the transactions on 01/01/2019?**
- **IFRS for SMEs accounting:** **how must SME account for the transactions on 01/01/2019?**

Mini-case study: the IFRS for SMEs (continued)

- **SME's profit for the year ended 31/12/2019:** 10,000 GEL.
- **At 31/12/2019:**
  - the carrying amount of SME's net assets/equity = 410,000 GEL; and
  - the fair value of SME's net assets/equity = 550,000 GEL (equivalent to 220,000 USD at 01/01/2020 spot exchange rate of 2.5 GEL : 1 USD).
- **In economics how much is SME's net income (income – expenses) for 2019?**
- **In accordance with the IFRS for SMEs, how much is SME's net income (income – expenses) for 2019?**
- **What are the root causes of the difference in net income between the IFRS for SMEs accounting and the economics?**

Mini-case study: the IFRS for SMEs (continued)
Scenario A

» **On 01/01/2020:**
  » the fair value of A’s interest in SME is determined to be 275,000 GEL (equivalent to 110,000 USD at 01/01/2020 spot exchange rate of 2.5 GEL : 1 USD).
  » **Scenario A:** B acquires all of A’s SME shares in exchange for 110 000 USD paid directly to A by B.

» **From SME’s perspective, what is the economics of the transaction on 01/01/2020?**

» **In accordance with the IFRS for SMEs, how, if at all, must SME account for the transactions on 01/01/2020?**

Mini-case study: the IFRS for SMEs (continued)
Scenario B

» **Facts are the same as Scenario A, except on 01/01/2020:**
  » **Scenario B:** SME acquires all of A’s SME shares in exchange for:
    » 100 000 USD paid by SME; and
    » 10 000 USD paid directly to A by B.

» **From SME’s perspective, what is the economics of the transactions on 01/01/2020?**

» **In accordance with the IFRS for SMEs, how, if at all, must SME account for the transactions on 01/01/2020?**

Accounting for an SME's purchase of shares in its subsidiary from the non-controlling interests (NCI)

Context questions: NCI

» **Question 1:** is accounting for non-controlling interest (NCI) **as equity** (in the statement of financial position) consistent with the definition of equity?

» **Question 2:** is the measurement of NCI in the accounting for a **business combination** in accordance with the IFRS for SMEs consistent with the economics of the NCIs' claim?

SME ‘buys shares in its subsidiary from the NCI’

» **Question 1:** from SME Group’s perspective, what is the economics of the parent buying shares in its subsidiary from the NCI?

Overview of **IFRS for SMEs accounting** for buying share in its subsidiary from the NCI, from SME Group’s perspective (paragraph 22.19):

- » asset cash (the fair value of the consideration paid) reduces
- » the carrying amount of the NCI is reduced to reflect the proportionate change in its interest in the net assets of the reporting SME group
- » the difference is recognised directly in equity attributed to owners of the parent

Consolidated financial statements
Example: ‘acquisition’ of the NCI

» Since its formation Z was owned 75% by A and 25% by B.

» When Z’s equity was GEL 100,000, A acquires B’s 25% interest in Z at its fair value of GEL 60,000.

Question 1: how would A present the acquisition of the shares in Z in its consolidated statement of changes in equity? Choose one of:

1) GEL 25,000 as a reduction in NCI?
2) GEL 60,000 as a reduction in NCI?
3) GEL 25,000 as a reduction in NCI and GEL 35,000 as a reduction in equity attributable to the controlling shareholder (eg retained earnings).

Consolidated financial statements
Example: 'acquisition' of the NCI (continued)

» **Question 2: is the accounting consistent with the element definitions (ie asset, liability, equity, income and expense)?** Choose one of: 1) Yes; or 2) No.

» **Question 3: is it anomalous that equity attributed to owners of the parent is adjusted by the difference (see accounting above)?** Choose one of: 1) Yes; or 2) No.

Mini-case study: piecemeal acquisition and piecemeal disposal of a subsidiary

Mini-case study: piecemeal acquisition of a subsidiary: the IFRS for SMEs

- 01/01/2000 Acquirer purchases a 25% equity interest in Acquiree from FamilyBusiness at a cost of 10 million. In accordance with it accounting policy for investment in associates Acquirer accounted for its investment in Acquiree using the cost model.
- In 2000 Acquirer accounts for its investments in associates using the cost model.
- **Questions:**
  - **What is the economics of an investment in an associate?**
  - **Which of the alternative measurement models reflects most of the economics about an investment in an associate: (i) the cost model; (ii) the fair value model; or (iii) the equity method?**
  - **Which of the alternative measurement models provides the most relevant information: (i) the cost model; (ii) the fair value model; or (iii) the equity method?**
  - **Can Acquirer change its accounting policy for investments in associates from the cost model to the fair value model?**
  - **If Acquirer changed its policy from the cost model to the fair value model, could it at a later date revert to using the cost model?**

Mini-case study: piecemeal acquisition of a subsidiary: the IFRS for SMEs

On **01/01/2001** Acquirer gained control of Acquiree by purchasing a further 50% of Acquiree's equity from FB in exchange for 25 million. In the initial accounting for the business combination Acquiree recognised non-controlling interest (NCI) and measured it in accordance with the IFRS for SMEs at 10 million.

Question: assuming that the transaction on 1 January 2001 is priced at the market:

- **what is the economics of the transaction?**
- **is the accounting for the transaction specified in paragraphs 14.8(i)(i) and 19.11 of the IFRS for SMEs consistent with the economics?**

Mini-case study: piecemeal acquisition of a subsidiary: the IFRS for SMEs

On **01/01/ 2015** Acquirer purchases the remaining 25% of Acquiree's equity from FB in exchange for 50 million. In Acquirer's consolidated statement of financial position at 31/12/2014, FB' claim against the group was recorded in NCI at 20 million.

Question 3: assuming that the transaction on 01/01/2015 is priced at the market:

a. **what is the economics of the transaction?**
b. **is the accounting for the transaction specified in paragraph 22.19 of the IFRS for SMEs consistent with the economics?**

Mini-case study: piecemeal disposal of a subsidiary: the IFRS for SMEs

» On **01/01/ 2019**, Acquirer disposes of 50% of its equity interest in Acquiree for 60 million when the group carrying amount of Acquiree's net assets is 80 million (Note: the goodwill that arose on the acquisition of Acquiree is fully amortise or impaired, ie its carrying amount is nil).

» **Question 4: assuming that the transaction on 01/01/2019 results in Acquirer losing control over Acquiree:**

a. **what is the economics of the transaction?**
b. **is the accounting for the transaction specified in paragraphs 9.18 and 9.19 of the IFRS for SMEs consistent with the economics?**

Mini-case study: piecemeal disposal of a subsidiary: the IFRS for SMEs

- On **01/01/ 2019**, Acquirer disposes of 50% of its equity interest in Acquiree for 60 million when the group carrying amount of Acquiree's net assets is 80 million (Note: the goodwill that arose on the acquisition of Acquiree is fully amortise or impaired, ie its carrying amount is nil).
- **Question 5: assuming that the transaction on 01/01/2019 does not result in Acquirer losing control over Acquiree:**
    a. **what is the economics of the transaction?**
    b. **is the accounting for the transaction specified in paragraphs 9.18 and 9.19 of the IFRS for SMEs consistent with the economics?**

THANK YOU for actively participating in the discussion!