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A86045 Accounting and Financial Reporting (2017/2018)

Session 6

Costs and Expenses

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SESSION 6 OVERVIEW AND SESSION OBJECTIVES

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Course Overview

PGS	1. Financial reporting under IFRS	14. Construction contracts	PGS
	2. Financial analysis: Ratio analysis	15. Other Non-financial liabilities	
	3. Financial analysis: Segments and EPS	16. Review session	
	4. Review session	17. Mid term test	
	5. Revenues	18. Financial Instruments 1	
	6. Costs and expenses	19. Financial Instruments 2	
	7. Taxation - Direct and Indirect	20. Review session	
	8. Non-current assets - Intangible assets	21. Cash Flow Statement	PT
	9. Non-current assets - Tangible assets	22. Group accounts/Business comb	
	10. Financial leases	23. Review session	
	11. Impairment of assets	24. Review session	
	12. Review session	25. Final test	PGS
PT	13. Inventories		

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Objectives of Session 6

At the end of this session session students will be able to:

1. **Recognize** and **understand** the difference between a statement of profit and loss with the costs and expenses presented by nature and by function.

2. **Calculate** cost of goods sold/cost of sales

3. **Understand** the accounting for short-term and long-term employee benefits including payroll expenses, stock options, pensions and other employee benefits.

Session 6 Overview

	Mins
Session objectives and overview	5
Review of pre-work and session 5 recap	5
Classification of Costs and Expenses	5
Cost of Sales	5
Other costs and expenses	5
Research assignment RA 4 Employee benefits	20
Employee expenses (Payroll, Share-based payments, Post Employment Benefits (OPEBs), Class exercise	35
Required reading and assignment for next session	5
Summary and validation of session 6	5
	90

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SESSION 5 RECAP AND PRE-WORK

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Session 5 Summary

- Revenues – largest number in the income statement and the area most susceptible to manipulation
- Five step approach to revenue recognition
- Importance of industry context and understanding
- Framework for revenue recognition
- IFRS 15 now supercedes IAS 18 and IAS 11

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Session 5 Validation

- What is the 5 step approach to recognizing revenues under IFRS 15?
- What are the 5 conditions that need to be satisfied in order to account for a contract with a customer under IFRS 15?
- How do we account for revenues from construction contracts?
- What criteria must be satisfied to account for performance obligations in a multiple-element transaction? And how is revenue allocated among the different elements?

Session 6 Pre-work

- Reading
  - Melville International Financial Reporting A Practical Guide:
    - Chapter 13 – Revenues from contracts with customers
  - IFRS
    - IFRS 15 - Revenues from contracts with customers
- Exercises
  - Melville 13.1 – 13.6
  - Melville On-line multiple choice questions for chapter 13
  - Exercise EX 5 Revenues
- Research assignment RA 4 Employee benefits

Research Assignment RA 4 Employee benefits

Company____________

IAS 19		*Provide a brief description as to whether these items are present and, if so, the company's accounting policy for these*
Short-term benefits	Services rendered	
	Paid absences	
	Profit sharing	
Long-term benefits	Termination indemnities	
Post-employment benefits	Defined benefit plans Defined contribution plans Other post-employment benefits	
IFRS 2		
Share-based payments	Equity settled Cash settled	

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CLASSIFICATION OF COSTS AND EXPENSES

Classification of costs and expenses

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SM 1

Session 1 SM3 Profit and Loss Account by Nature and by Destination

Expenses by nature

Expenses by Function or Destination

Session 4

		Revenues	Cost of sales	Gorss profit	Other operating income	Selling and distribution expenses	Adminstrative expenses	Other operating expenses	Operating profit	Finance costs	Finance income	Share of profit of associate and JV	Profit before tax Cont operations	Income tax expense	Profit for the year from cont operations	Profit after tax from discont operations	Profit for the year
Continuing operations																	
Revenues	180,462	180,462															
Other operating income	1,584				1,584												
Changes in inventories	(1,134)		(1,134)														
Raw materials and consumables	(127,739)		(127,739)														
Employee benefits expense	(35,880)		(3,451)			(14,001)	(18,428)										
Depreciation and amortization	(3,922)		(3,922)														
impairment on non-current assets	(200)		(200)														
Other expenses	(1,153)		(2)					(1,151)									
Finance costs	(2,766)									(2,766)							
Finance income	1,186										1,186						
Share of profit of associate and JV	671											671					
Profit befor tax from continuing operations	11,109																
Income tax expense	(3,098)													(3,098)			
Profit for the year from continuing operations	8,011																
Discontinued operations																	
Profit after tax from discontinued operations	220																
Profit for the year	8,231															220	
		180,462	(136,448)	44,014	1,584	(14,001)	(18,428)	(1,151)	12,018	(2,766)	1,186	671	11,109	(3,098)	8,011	220	8,231

Session 19

Session 23

Session 5

Sessions 6, 8, 11

COST OF GOODS SOLD (COGS)

Cost of Goods Sold (COGS)

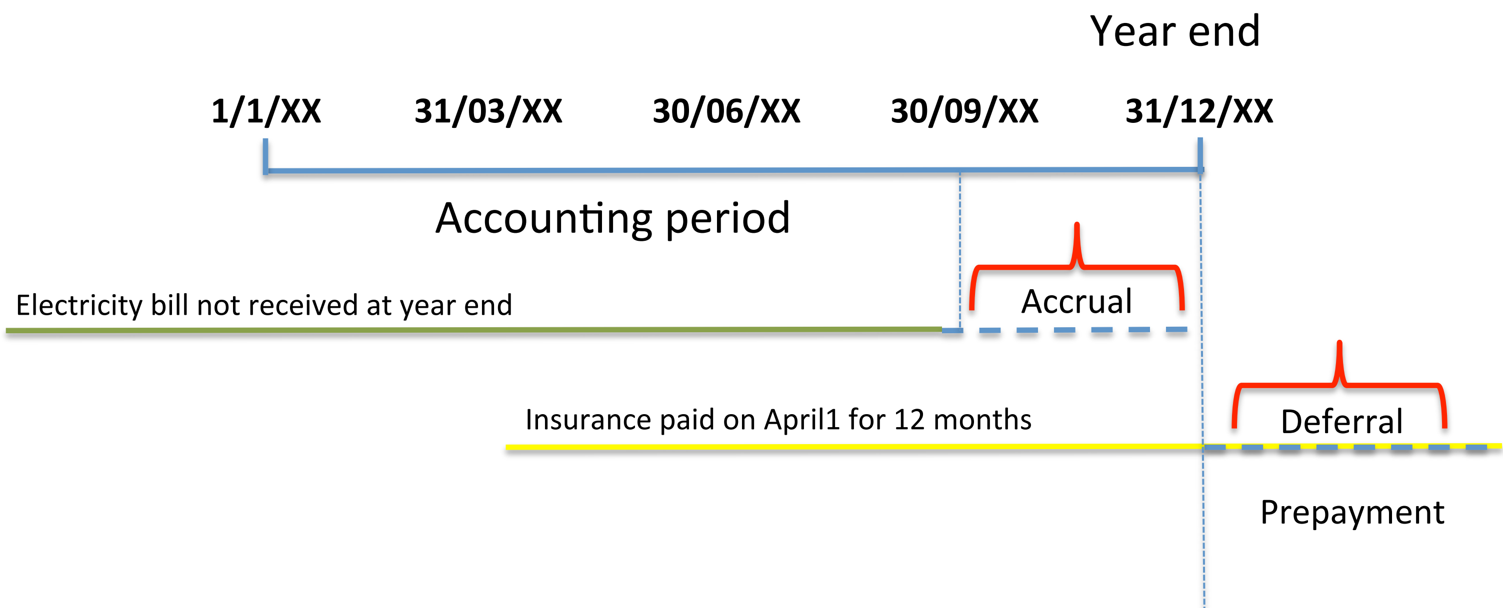
Opening inventory		100		
Purchases		2,000		2,000
		2,100	OR	
Closing inventory		(150)		
Change in inventory	(100 – 150)			(50)
Cost of goods sold		1,950		1,950

Cost of goods sold (COGS) is the same as Cost of Sales (COS)

We will look at methods of valuing inventories in Session 13

OTHER COSTS AND EXPENSES

Other Costs and Expenses



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EMPLOYEE BENEFITS – IAS 19

Employee expenses

- Short-term benefits
  - Services rendered – payroll expenses, soc security
  - Paid absences – vacation pay, sick pay
  - Profit sharing/bonuses
  - Non-monetary benefits – cars, phones, health care
- Long-term benefits – termination indemnities
- Post employment benefits (PEB)
  - Pensions
  - Healthcare
- Share-based compensation – IFRS 2

Short-term employee benefits

IAS19 defines short-term employee benefits as "*employee benefits … that are expected to be settled wholly before twelve months after the end of the … period in which the employees render the related service*". These include:

- wages, salaries and employer's social security contributions
- short-term holiday pay and sick pay
- bonuses payable within 12 months of the end of the period in which the related services are performed
- non-monetary benefits for current employees.

Financial statements should recognise as an expense the short-term benefits due to employees for services rendered during the accounting period.

RESEARCH ASSIGNMENT RA 4
EMPLOYEE BENEFITS

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Research Assignment RA 4 Employee benefits

Company____________

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	Paid absences	
	Profit sharing	
Long-term benefits	Termination indemnities	
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IFRS 2		
Share-based payments	Equity settled Cash settled	

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PAYROLL EXPENSES

Payroll expenses

Company perspective

Employee perspective

	Basic Salary	Company's social charges	Termination indemnity	Total cost to company
Employee's gross salary	**50,000**	**15,000**	**5,000**	**70,000**
Social charges	**(5,000)**			
Income taxes	**(15,000)**			
Employee's net salary	**30,000**			

What are the accounting entries to record payroll expense?

Payroll expenses - accounting

Dr payroll expense	50,000	
Dr termination indemnity expense	5,000	
Dr social security expense	15,000	
Cr social security liability (15,000 + 5,000)		20,000
Cr termination indemnity provision		5,000
Cr income tax authorities		15,000
Cr cash		30,000
	70,000	70,000

Other short-term employee benefits

- Holiday/vacation pay – if accumulating
- Profit sharing/bonuses – if present obligation
- Pension scheme contributions
- Non-monetary benefits
  - Car
  - Phone
  - Medical care

These need to be accrued for if they have not been paid at the end of the financial year

POST EMPLOYMENT BENEFITS

Post employment benefits - Pensions - IAS 19

Defined benefit

- The plan defines the benefits that an individual will receive based on a number of factors such as age, years of service and compensation.

Defined contribution

- The plan specifies how an individual's contributions are determined as opposed to the benefits that they will receive

The company's obligation is to provide the agreed benefits therefore the actuarial risk and investment risk fall on the company.

Fixed cost to the company and no further obligation once liability is settled.

Funded vs. Unfunded

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Defined benefit plans

Company contributions

Employee contributions

Plan Assets

Cash

Investments

Estimate of future pension liability

Defined benefit obligation (DBO)

Funds invested to generate sufficient funds to meet the DBO

Can be managed in the company or by a third party

Accounting for **defined benefit** plans and other post employment benefits

An Actuarial Valuation is normally Required

Assumptions required (also to be disclosed)

- Discount rate
- Inflation
- Rate of increase in salaries
- Rate of increase in pension payments
- Long-term medical cost inflation
- Expected long-term rates of return:
  - Equities
  - Bonds
  - Property
  - Others
- Life expectancies/mortality rates

Both the future value of the Plan Assets and the Benefit Obligation are both the subject of estimates

Accounting for defined benefit plans

a) Determine the deficit or surplus. This involves:
   a) Using an actuarial technique such as the "projected unit credit" method to estimate the ultimate cost to the entity for service in current and prior periods and make estimates about demographic and financial variables
   b) Discounting the benefit to determine the net present value
   c) Deducting the fair value of any plan assets
b) Determining the amount of the net defined benefit liability/asset
c) Determining the amount to be recognized in profit and loss:
   a) Current service cost
   b) Any past service cost and gain or loss on settlement
   c) Net interest on the net defined benefit liability (asset)
d) Determining the re-measurements of the net defined benefit liability (asset) to be recognized in other comprehensive income comprising:
   a) Actuarial gains and losses
   b) Return on plan assets
   c) Any change in the effect of the asset ceiling

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Unilever Pension Fund

Unilever 2014 £ millions	Pension Assets	Pension Liabilities	Profit & Loss	Other Comprehensive Income	Cash	Other
January 1	18,319	(20,296)				
Current service cost		(259)	259			
Employee contributions	16		(16)			
Special termination benefits		(27)	27			
Past service costs including gains/ losses on curtailment		87	(87)			
Settlements	(3)	13	(10)			
Actual return on plan assets	1,316			(1,316)		
Interest income (cost)	780	(874)	94			
Actuarial gains and losses						
Changes in demographic assumptions		(28)		28		
Changes in financial assumptions		(3,076)		3,076		
Experience adjustments		78		(78)		
Employer contributions	537				(537)	
Benefit payments	(1,251)	1,251				
Reclassifications	(3)	(14)				(17)
	19,711	(23,145)	267	1,710	(537)	(17)
Currency translation	773	(910)		137		
December 31	20,484	(24,055)	267	1,847	(537)	(17)
Net Liability Presented as		(3,571)				
Non-current assets - Plans in surplus	376					
Non-current liabilities - Plans in deficit		(3,947)				
Net cost Presented as						
Defined benefit plans			173			
Defined contribution plans			115			
			288			
Finnace cost			94			
			382			

Assumptions	
Discount rate	3.1%
Inflation	2.4%
Rate of increase in salaries	2.8%
Rate of increase in pensions payment	2.2%
Rate of increase for pensions deferment	2..5%
Long-term medical cost inflation	5.4%
Number of years a current pensioner is expected to live beyond 65	
Men	22.4
Women	24.5
Number of years a future pensioner is expected to live beyond 65	
Men	23.6
women	26.3
Assets investments	
Equities	
Europe	2,957
North America	3,086
Other	2,293
	8,336
Fixed income	
Government Bonds	4,654
Investment Grade Corporate Bonds	2,749
Othe Fixed Income	1,478
	8,881
Derivatives	-1,182
Private Equity	762
Property and Real Estate	1,384
Hedge Funds	1,050
Other	963
	2,977
Other	290
	20,484

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SM 3 Pensions Comparison

	Barclays	L'Oreal		Nestlé		Siemens	Vodafone
Notes	£	€		CHF		€	£
Defined benefit obligation	(33,033)	(4,476)		(30,049)		(36,871)	(7,303)
FV Plan assets	32,657	3,765		22,994		27,606	6,709
Surplus (Deficit)	(376)	(711)		(7,055)		(9,265)	(594)
Shareholders Equity	71,365	24,504		65,981		44,527	73,719
Financial Statemet Presentation							
Retirement benefit assets	14			310		317	57
Retirement benefit liabilities	(390)	(711)		(8,420)		(9,582)	(651)
	(376)	(711)		(8,110)		(9,265)	(594)
Assumptions							
Life expectancy							
Males at 60	27.9			26.9		Country	
Females at 60	29.7			28.9		Tables	
Discount rate	2.6	2.4		3.0		2.4	2.6
Inflation rate	3.4	5.7	Hcare	6.2	Hcare		3.0
Salary increases		3.9		3.0		3.7/1.5	2.6
Long-term return on plan assets		2.3					
Expected rate of pension adjustments				1.1		1.4/3.0	

SHARE BASED COMPENSATION – IFRS 2

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Share-based payments - Stock Options

Cost of option recognized in P&L over this period (Adjusted annually)

No further adjustment once vested

Grant Date Vesting Date Exercise Date Lapse Date

Vesting conditions
- Service
- Performance

The Fair value of the option is measured at the Grant Date

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Stock Options – Valuation

An Actuarial Valuation is normally Required

Option Value = Intrinsic value + Time Value

Intrinsic value:
Share price
Less
Exercise price

Time Value:
Volatility
Interest rate
Time to expiration
Dividend rate

Employee options:
Vesting period
Early exercise
Non-transferability
Performance hurdles

Option pricing models:

- *Black-Scholes-Merton*
- *Binomial*
- *Monte Carlo Simulation*

Stock Options – Accounting

Cash settled

Dr Employment costs

Cr Liability

Equity settled

Dr Employment Costs

Cr Equity

If options are modified, cancelled or even not exercised, the cost is not modified or reversed

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CLASS EXERCISE

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Class Exercise

An entity grants 100 share options to each of its 500 employees. Vesting is conditional upon the employees working for the entity over the next three years. The entity estimates that the fair value of each share option is € 15. The entity estimates that 20% of the original 500 employees will leave during the three year period and therefore forfeit their rights to the share options.

If everything turns out exactly as expected, calculate the amounts the entity will recognize during the vesting period for services rendered as consideration for the share options.

Class exercise - solution

Year	Calculation of cumulative expense	Cumulative expense €	Expense for the period
1	50,000 options x 80% x €15 x 1/3	200,000	200,000
2	50,000 options x 80% x €15 x 2/3	400,000	200,000
3	50,000 options x 80% x €15 x 3/3	600,000	200,000

REQUIRED READING AND ASSIGNMENT FOR NEXT SESSION

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Overview of Session 7

Types of taxation

- Direct
- Indirect

Value added taxes

Current income taxes

- Taxable income/expense
- Non-taxable income expenses

Deferred income taxes

- Temporary differences
- Permanent differences

Reconciliation of tax charge – Effective tax rate

Uncertain tax positions

Session 7 Pre-work

- Reading
  - Melville International Financial Reporting – A Practical Guide :
    - Chapter 14 – Employee benefits
  - IASB Statements
    - IAS 19 Employee benefits
    - IFRS 2 Share-based payments
- Exercises
  - Melville 14.1 – 14.6
  - Melville on-line multiple choice questions for chapter 14
  - Ex 6 Costs and expenses - Exercises
- Research assignment
  - RA 5 Income taxes accounting policies and effective tax rates

RA 5 Income taxes

Company__________

Accounting Policy for income taxes

RA 5 Income taxes

Company__________

Effective tax rate

Reasons why this is different from the statutory tax rate

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SUMMARY AND VALIDATION

Session 6 Summary

- Classification of costs/expenses by nature or by destination
- Cost of goods sold
- Other costs/expenses – accruals/deferrals
- Employee expenses
  - Short-term benefits – Wages and salaries
  - Post employment benefits - Pensions
  - Share-based payments - Stock options

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Session 6 Validation

- What is the difference between a defined benefit plan and a defined contribution plan?
- Which would you prefer to have?
- Over what period is the cost of the fair value of a stock option recognized?
- What is the difference between an accrual and a prepayment/deferral?
- How do you calculate COGS/COS?