Accounting SOLUTIONS

By: Neville Cutajar

SCENARIO 1: EXECUTIVE CALL OPTIONS

A company has a system of rewarding its management by providing share options. On 1st April 2008 the company granted ten executives call options to purchase up to 5,000 shares each on 1 April 2010. This was partly a means of deferring them from leaving as the options only vest if the executives would have still to be employed on 1 April 2010. The HR manager estimates that 90% of the executives will remain with the company for the two year period and exercise their options in full. The following information is available for each option.

(i) The option price is €20 per share.
(ii) The market value of each share was €15 on 1 April 2008 and €18 on 31st March 2009.
(iii) The market value of the share option was €2 on 1 April 2008 and €2·20 on 31 March 2009.

IFRS 2 – *Share Based Payment* – requires entities to recognise obligations that will be settled in shares – equity settled share based payments – at either the market value of the goods or services provided by the recipients of the payment or at the market value of the share based payment, whichever is the easier to ascertain. In the case of share based payments to employees the market value of the share based payment is to be used. The market value should be measured at the date the award is granted, not the date the amounts [in this case share options] vest.

The market value of a share option at 1 April 2008 was $2 and so the market value of the expected award is €2 x 10 x 5,000 x 90% = €90,000. The option has a market value even though it has no intrinsic value either at granting date or currently. This is so because of expectations regarding the future share price. Since the award is based on service over a two year period then the charge to income for the year ending 31st March 2009 is 1/2 x 490,000 = €45,000. An equivalent amount will be credited to equity and will be included in the future proceeds of issue of the shares, assuming the options are exercised.

SCENARIO 2: RESTRUCTURING AND CLOSURE OF OPERATIONS

In 2009 a company, with a financial year ending 31st March, entered into negotiations with employee representatives to restructure its operations and close down two of five retail outlets. Broad agreement was reached with the union representatives on 25 March 2009 and the plans publicly announced on 27 March 2009. Relevant employees were sent letters on 28 March 2009 offering them redundancy or redeployment. The restructuring was completed on 31 May 2009. The financial effects of the closure were as follows:

(i) The company incurred closure costs of €1 million, including redundancy payments of €400,000.
(ii) Costs of redeploying existing employees totalled €200,000.
(iii) Plant and equipment was scrapped at a loss of €150,000.
(iv) The properties of the two outlets were sold at a profit of €300,000 after year end.
(v) The operating losses of the two outlets from 1 April 2009 to 31 May 2009 totalled $100,000.
(vi) The net sum of all the above is a cost of $1,150,000.

A provision for the consequences of the reorganisation is required in principle. This is because the decision to close was communicated to those affected before the year end and so, under the principles of IAS 37 – Provisions, Contingent Liabilities and Contingent Assets – there is a constructive obligation to restructure at 31 March 2009. The amount to be provided for is to take the following in consideration:

- The provision should be for the direct consequences of the decision to close and should not include items relating to the on going operations of the business. Therefore redeployment costs should not be included.
- The provision should not include any amounts relating to future operating losses unless they arise under an onerous contract.
- The provision should not be reduced by potential gains on future asset sales but the estimated losses on the sale of plant should be recognised.

IFRS 5 – Disposal of Non-current Assets and Reporting of Discontinued Operations states that assets held for sale should be measured at the lower of carrying amount and fair value less costs to sell. An asset is classified as held for sale if its value will be recovered principally through sale as opposed to continuing use. The assets of the two outlets would appear to satisfy this definition. The potential loss on sale of plant is not part of the restructuring provision as such but will need to be reflected in a lower carrying value for the plant.

Under the principles of IFRS 5 it would be correct to show the results separately if the retail outlets can be regarded as a discontinued operation. For this to be the case the outlets would have had to satisfy the following conditions:

(i) Being a component of the entity (operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity) that either has been disposed of or is classified as held for sale; and

(ii) – A separate major line of business or geographical area of operation; or
– Part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or
– A subsidiary acquired exclusively with a view to resale.

In this case the retail outlets cannot be regarded as a discontinued operation since neither condition is satisfied. Condition (i) isn't satisfied since the retail outlets being closed are not deemed as a separate component (I.e. a SBU) of the entity whilst condition (ii) isn't satisfied since It is expected that the markets served by the two outlets are going to be supplied by the remaining outlets and therefore no geographical area of operation or market has been discontinued.

This means that in respect to year ending 31st March 2009 a provision will be made for €1 million, with an impairment loss on plant and equipment of €150,000.

About the author

Neville Cutajar is 3a Accountants (www.3a.com.mt) managing partner and director. He is the firm's technical partner in relation to International Financial Reporting Standards. He is also the partner in charge in respect of compliance and quality control issues at 3a. He has ample experience in management consultancy, internal auditing as well as information systems audits. He may be contacted on neville@3a.com.mt.