South African Institute of Taxation

Comprehending other comprehensive income (OCI)

A conversation about other comprehensive income

YOUR KEY TO THE TAX COMMUNITY

Welcome

On the lunch plate today

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1. **Tax focus points** touching on other comprehensive income

2. **Accounting focus points** touching on other comprehensive income
    a) What is **other comprehensive income**?
        - ✓ Characteristics
        - ✓ Examples of how it can arise
        - ✓ Presentation and disclosure in the AFS
    b) **What is recognised** in OCI?
    c) **Releasing** amounts from OCI
        i. To profit or loss
        ii. To other reserves

3. Conclusionary remarks

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Tax focus points touching on OCI

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- No specific tax consequences
  - Timing issue
  - Tax will arise when the transaction is realised from a tax perspective, i.e., when the disposal occurs, and CGT becomes relevant (mostly subject to CGT)
    - 80% inclusion rate, 28% or 27% tax rate
  - Therefore, this becomes a tax reconciling item that must be reversed where it has impacted P/L (profit before tax)
  - Look out for these movements in the TB/Financial statements

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The prevalence of other comprehensive income?

The International Accounting Standards Board (IASB) identified the single most prevalent reason for non-adoption of the IFRS for SMEs before the 2015 amendments, to be the fact that classes of property, plant and equipment could not be revalued to their fair values.

Revaluation of PP&E is recognised in other comprehensive income.

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What is other comprehensive income?

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CHARACTERISTICS

- ✓ Commonly referred to as "OCI"
  - ✓ *"Statement of profit or loss and other comprehensive income (SPLOCI)"*
- ✓ OCI forms part of equity, but <u>not</u> contributed by the shareholders
- ✓ Most fair value adjustments on assets and liabilities are recognised in OCI
  - ✓ *More fair value adjustments are performed in full IFRS, than in the IFRS for SMEs*
  - ✓ *An entity's own equity instruments are not revalued*
- ✓ Corresponding tax amounts relating to fair value adjustments, are also recognised in OCI
  - ✓ This would be deferred tax, and not actual tax!
- ✓ Are all fair value adjustments recognised in OCI?
  - ✓ *No, mostly those <u>not</u> relating to the core day-to-day business activities of the entity*
  - ✓ *See example on next page…*

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What is other comprehensive income?

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- ✓ Example 1: Investment property (fair value adjustments recognised in profit or loss)

- ✓ Company ABC (Pty) Ltd owns a building which it fully rents out in terms of a lease with a tenant. The company earns R230 000 (including VAT) as rent per annum. At 30 June 2022, the entity's year-end, the fair value of the leased building had increased by R1,15 million (including VAT) from the previous fair value.

- ✓ Required: Process the journal entries for the year ended 30 June 2022

✓ Dr Bank	R230 000	
✓ Cr Rental income (P/L)		R200 000
✓ Cr Output VAT (SoFP)		R30 000
✓ Dr Investment property (SoFP)	R1 000 000	
✓ Cr Fair value gain (P/L)		R1 000 000
✓ Dr Income tax expense (P/L)	R224 000 (being R1m x 80% x 28%)	
✓ Cr Deferred tax (SoFP)		R224 000

P/L

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What is other comprehensive income?

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- Example 2: Equipment (fair value adjustments recognised in OCI)

- Company ABC (Pty) Ltd owns equipment with a cost price of R2 million (excluding VAT) that it uses in its production process. The company can claim a R400 000 capital allowance for tax, and the equipment depreciated (for accounting purposes) at R300 000 for the year ended 30 June 2022. At 30 June 2022, the company revalued the equipment by R500 000 (excluding VAT). Assume that the revaluation amount (R500 000) does not increase the equipment's carrying amount above the original cost (and base cost) thereof.

- Required: Process the journal entries for the year ended 30 June 2022

Dr Depreciation (P/L)	R300 000		P/L
Cr Accumulated depreciation (SoFP)		R300 000	
Dr Income tax expense (P/L)	R28 000 (being (R400 000 – R300 000) x 28%)		
Cr Deferred tax (SoFP)		R28 000	
Dr Equipment – at carrying amount	R500 000		OCI
Cr Revaluation surplus (OCI)		R500 000	
Dr Income tax expense (OCI)	R140 000 (being R500k x 28%)		
Cr Deferred tax (SoFP)		R140 000	

What is other comprehensive income?

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Statement of financial position at 31 December 2010

		Notes	2010 CU'000	2009 CU'000
4.9	**Assets**			
4.6	**Non-current**			
4.3	Goodwill	5	**1,008**	1,090
4.2(g)	Other intangible assets	5	**469**	262
4.2(e)	Property, plant and equipment	6	**23,155**	17,516
4.2(j)	Investments in associates		**922**	922
4.2(f)	Investment property	7	**907**	803
4.2(o)	Deferred tax assets	8	**243**	524
4.4	Non-current assets		**26,704**	**21,117**
4.5	**Current**			
4.2(d)	Inventories	9	**5,067**	6,267
4.2(b)	Trade and other receivables	10	**27,396**	20,066
4.3	Derivative financial assets	11	**–**	246
4.2(c)	Other short-term financial assets	11	**162**	102
4.2(n)	Current tax assets		**193**	–
4.2(a)	Cash and cash equivalents	12	**10,481**	7,145
4.4	Current assets		**43,299**	**33,826**
	Total assets		**70,003**	**54,943**
4.9	**Equity and liabilities**			
	Equity			
4.11(f)	Share capital	13	**7,570**	7,570
4.11(f)	Share premium		**5,224**	5,224
4.11(f)	Translation reserve		**(194)**	(173)
4.11(f)	Retained earnings		**27,200**	21,365
4.2(r)	Total equity attributable to owners of the parent		**39,800**	**33,986**
4.2(q)	Non-controlling interest		**3,434**	2,378
	Total equity		**43,234**	**36,364**
	Liabilities			
4.8	**Non-current**			
4.2(m)	Borrowings	14	**4,469**	6,089
4.2(o)	Deferred tax liabilities	8	**1,954**	1,429
4.4	Non-current liabilities		**6,423**	**7,518**
4.7	**Current**			
4.2(l)	Trade and other payables	15	**16,901**	9,576

Guidance note: Statement of financial position

The IFRS for SMEs provides a list of the minimum items to be presented on the face of the statement of financial position (4.2*). Management will need to apply judgement in determining whether additional line items are necessary to help users understand the entity's financial position (4.3). In the example, IPL has presented goodwill separately from other intangible assets because of its different nature. Derivatives used for hedging purposes are presented separately from other financial instruments due to their different function. Management may also consider presenting material items separately where this is done internally in managing the business and assessing performance.

The example statement of financial position includes a current/non-current distinction. Unlike IPL, some entities may not supply goods and services within a clearly identifiable operating cycle, eg investment companies, and a presentation based on liquidity may be more relevant. In such cases, all assets and liabilities are presented in order of approximate liquidity (ascending or descending) (4.4).

* References in brackets and in the left hand column of each page of the example financial statements refer to paragraphs within the IFRS for SMEs

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What is other comprehensive income?

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Universal Reporting (Pty) Ltd

Consolidated statement of comprehensive income
for the year ended 31 December 20XX

(ALTERNATIVE 2 – ILLUSTRATING THE CLASSIFICATION OF EXPENSES BY NATURE AND INCORPORATING OTHER COMPREHENSIVE INCOME)

	Notes	20XX	20XX-1	
Revenue	5	X	X	5.5 (a)
Other income	6	X	X	5.9
Changes in inventories of finished goods and work in progress		X	X	5.11 (a)
Raw material and consumables used		X	X	5.11 (a)
Employee salaries and benefits		X	X	5.11 (a)
Depreciation and amortisation expense		X	X	5.11 (a)
Impairment of property, plant and equipment		X	X	5.11 (a)
Other expenses		X	X	5.11 (a)
Finance costs	7	X	X	5.5 (b)
Profit before tax	8	X	X	5.9
Income tax expense	9	X	X	5.5 (d)
Profit for the year		X	X	5.9
Other comprehensive income				6.5 (a)
Items that may be reclassified subsequently to profit or loss:		X	X	6.5 (b)
Revaluation of property, plant and equipment	10	X	X	
Total Comprehensive Income		X	X	6.5 (e)

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What is other comprehensive income?

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Consolidated statement of changes in equity at 31 December 20XX

	Share Capital	Retained Earnings	Revaluation Reserve	Total	
Balance as at 31 December 20XX-2	X	X	X	X	
Profit for the year		X		X	6.3 (c) (ii)
Dividends		X		X	6.3 (c) (ii)
Balance as at 31 December 20XX-1	X	X	X	X	
Profit for the year		X		X	6.3 (c) (i)
Other comprehensive income			X	X	6.3 (c) (ii)
Dividends		X		X	6.3 (c) (iii)
Balance as at 31 December 20XX	X	X	X	X	

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NOTES TO THE FINANCIAL STATEMENTS

10. Other comprehensive income

	20XX	20XX-1	
Revaluation of land and buildings	X	X	
Defrerred tax origination from revaluation of land and buildings	X	X	29.40
	X	X	

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What is recognised in OCI?

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Most common examples

- ✓ Fair value adjustments not recognised in profit or loss
  - ✓ *What is recognised in P/L?*
    - ✓ *Fair value adjustments on speculative financial assets or financial liabilities*
    - ✓ *Fair value adjustments on certain other financial assets or financial liabilities (i.e., so designated)*
    - ✓ *Fair value adjustments on investment property*
- ✓ Fair value adjustments recognised in OCI?
  - ✓ Revaluation of classes of PP&E (e.g., land, buildings, equipment, plant and machinery, etc.)
  - ✓ Revaluation of intangible assets (only possible in full IFRS)
  - ✓ Fair value adjustments on certain financial instruments (e.g., non-speculative cash flow hedges measured at fair value in terms of hedge accounting principles)
  - ✓ The entity-specific *credit risk portion* of certain financial liabilities designated to be measured at fair value through profit or loss
  - ✓ Reserve created by the translation of a foreign operation's financial statements from its functional currency into the reporting entity's reporting currency (called the foreign currency translation reserve, or FCTR)
  - ✓ Certain fair value adjustments relating to pension funds (e.g., actuarial gains/losses on defined benefit plans)

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Releasing amounts from OCI

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How does the process of release work?

- ✓ Firstly, important to note: IFRS/IFRS for SMEs does not <u>prescribe</u> the timing for such releases, but does prohibit certain amounts from being released into profit or loss

- ✓ Two <u>types of releases</u> evident
  - ✓ Released from OCI into profit or loss (called "recycling"/"reclassification")
  - ✓ Released from OCI into other reserves (called "direct reserve accounting")

- ✓ For example: the IFRS for SMEs does not allow for the revaluation reserve/surplus to be recycled, but only for direct reserve accounting to be applied according to the company's policy. On the other hand, other items whose fair value movements are recognised in OCI, may be recycled, e.g., the fair value adjustments relating to cash flow hedges etc.

- ✓ The entity needs to define their policy for releasing amounts from OCI either through recycling or direct reserve accounting for each item whose fair value movements are recognised in OCI

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Releasing amounts from OCI

The revaluation surplus

- ✓ The logic for releasing the revaluation surplus from OCI into retained earnings through direct reserve accounting
  - ✓ A class of PP&E is revalued through OCI according to entity policy
  - ✓ The depreciation on the revalued PP&E increases due to the revaluation, and is therefore "overstated/inflated" in the P/L to the extent of the revaluation
  - ✓ An amount equal to the **post-tax** depreciation amount, is released directly from OCI into retained earnings at the end of each financial year
  - ✓ This effectively "offsets/compensates" (directly within reserves) for the impact of the inflated depreciation on P/L, and "corrects" the retained earnings outside of P/L
  - ✓ *Some also view this adjustment as releasing the "realised" portion of the revaluation surplus to retained earnings, as the underlying asset is used over its useful life*
  - ✓ Why not recycle/reclassify the OCI to P/L in the first place?
    - ✓ Depreciation is the process of allocating the cost price of the asset to the benefits generated by that asset (i.e., which costs were incurred to produce those benefits for that period?)
    - ✓ Revaluation is the process of getting the asset's carrying amount to reflect more accurately the *actual benefits* that can be produced by that asset (i.e., there is a component of the carrying amount that does not reflect the cost price of the asset)

Releasing amounts from OCI

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The revaluation surplus (example)

- ✓ Company ABC (Pty) Ltd depreciated a **revalued** machine as follows for the current year:

✓ Pre-tax depreciation on historic (non-revalued) carrying amount	R500 000
✓ Pre-tax depreciation on revalued portion of carrying amount	R300 000
✓ Total depreciation for the year	R800 000
✓ Tax consequences of historic depreciation (R500k x 28%)	(R140 000)
✓ Tax consequences of revalued depreciation (R300 000 x 28%*)	(R84 000)
✓ Net effect of depreciation on equity	R576 000

- ✓ Journal entries for the current year?

✓ Dr Depreciation (P/L) (being R500 000 + R300 000)	R800 000	
✓ Cr Accumulated depreciation - machinery (SoFP)		R800 000
✓ Dr Revaluation surplus (OCI)	R216 000	
✓ Cr Retained earnings (equity)		R216 000

(being R300 000 depreciation – R84 000 tax consequence on additional depreciation)*

Direct reserve accounting

(*) For sake of simplicity, it has been assumed that the tax rate applicable to the revaluation amount is 28% and that no CGT consequences would result from the revaluation, as the revalued carrying amount is below the base cost of the machine.

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Releasing amounts from OCI

The revaluation surplus (continued)

✓ How do we see the previous release in the financial statements?

Company ABC (Pty) Ltd
Statement of changes in equity for the year ended 30 June 2022

	Share capital	Retained earnings	Revaluation surplus
Opening balance as at 1 July 2021	**XXX**	**XXX**	**XXX**
Net profit for the year	-	XX	-
Other comprehensive income (revaluation)	-	-	XX
Transfer from other comprehensive income	-	R216 000	-
Transfer to retained earnings	-	-	(R216 000)
Dividends paid	-	(R50 000)	-
Closing balance as at 30 June 2022	**XXX**	**XXX**	**XXX**

Releasing amounts from OCI

Which items of OCI can be reclassified into P/L?

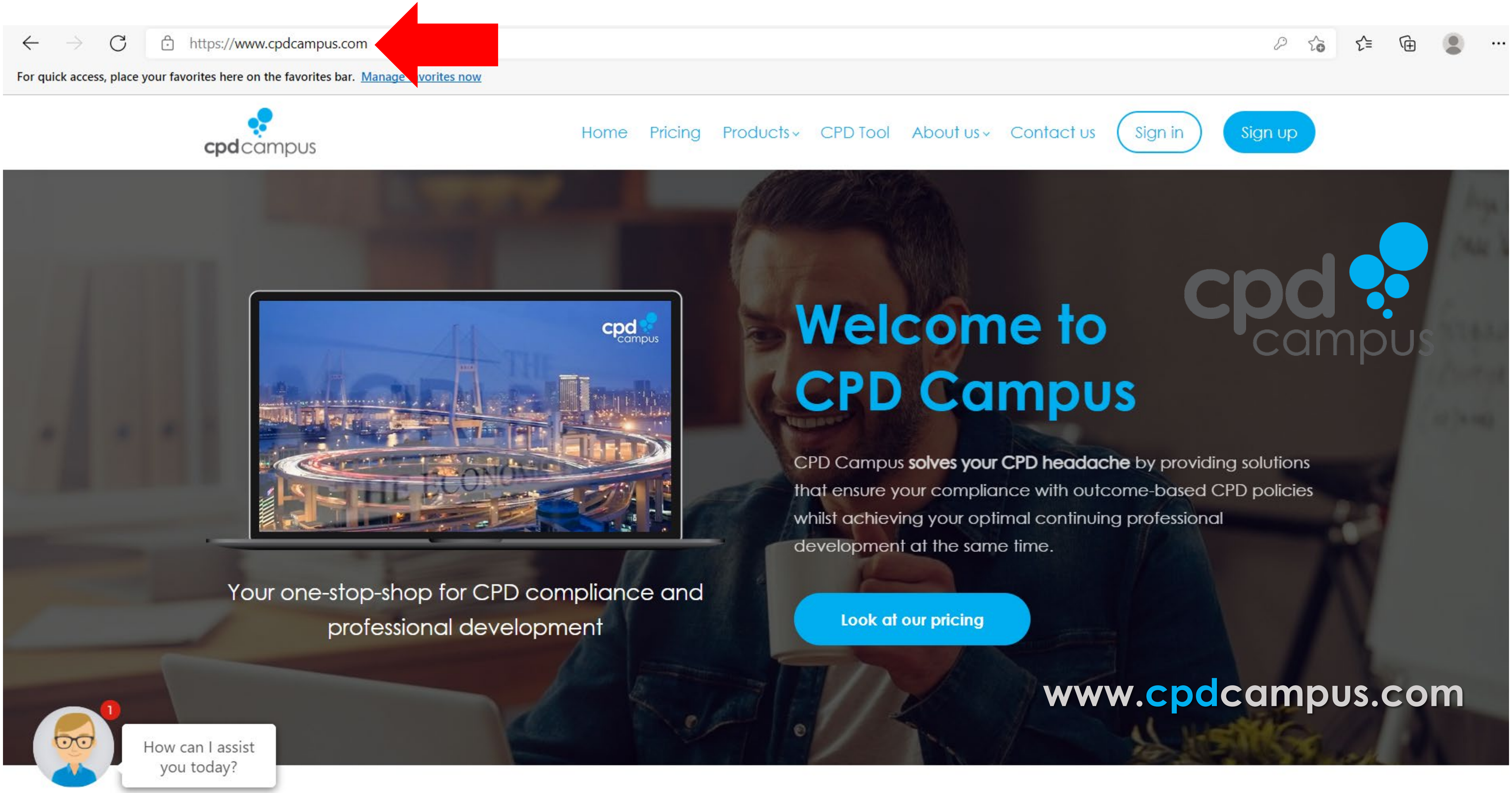
Reclassification = recycling = same thing!

OCI items that <u>can</u> be reclassified into profit or loss

- ✓ Foreign exchange gains and losses arising from translations of financial statements of a foreign operation (i.e., the FCTR)
- ✓ Effective portion of gains and losses on hedging instruments in a cash flow hedge

OCI items that <u>cannot</u> be reclassified into profit or loss

- ❖ Changes in revaluation surplus
- ❖ Actuarial gains and losses on defined benefit plans
- ❖ Gains and losses from investments in equity instruments measured at fair value through OCI (IFRS 9)
- ❖ For those liabilities designated at fair value through profit or loss, changes in fair value attributable to changes in the liability's credit risk (IFRS 9)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