Application of LKAS 16 & LKAS 39

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Introduction

PQR Lanka is a non-profit organization in Sri Lanka. The organization was registered in 1995 with the mission and vision to provide assistance and help to those who are living under the poverty line and to help people who were affected by the war in Sri Lanka. This case is relating to an issue of identification criteria of Property, Plant & Equipment.

Discussion of the Issue

PQR Lanka has given a loan to employees to buy motor cycles for the use of employees. Motor cycles are used by employees for both private use and to transport resident to work place. Motor bicycles are registered under the company name. Therefore company recognized this to financial statements as Property Plant and Equipment passing following journal entry.

Motor vehicle (PPE)	Dr	xxx	
Cash	Cr		xxx

Because of being identifying this asset as PPE, company has recognized a depreciation expense to Profit or Loss account.

Cost of these motor bicycles is recovered from employees by deducting employees' salary from 36 installments. At the time of deducting installment following double entry is passed.

Salary control Account	Dr	xxx	
Staff Loan Account	Cr		xxx

Passing above entry, company is identifying a liability as well. At the end of three years company has a liability which matches with the motor bicycle cost. When they dispose the asset they set off the asset against the identified liability by passing following double entry.

Staff Loan Account	Dr	xxx	
Motor Vehicle	Cr		xxx

Implications of the Issue

- Overstated property plant and equipment.
- Non-compliance with LKAS 16.
- Depreciation expense is over stated and the profit is understated.
- Users of the financial statement will mislead about the financial position of the company.

Recommendations

The best treatment for this transaction is to recognize as the "Loan given to the employees" rather than "PPE" for a fair presentation of financial statement.

According to the paragraph 7 of the LKAS -16 "Property plant and equipment", Property plant and equipment shall be identified as an asset, if:

- ✓ ***It is probable that future economic benefit associated with the item will flow to the entity.***
- ✓ ***The cost of the item can be measured reliably.***

Even though the legal ownership of the asset is with the company, sometimes future economic benefit will not be flow to the entity if employees use this asset only to their private use. As well as the company acquired and registered the bicycle under their own name only as a pledge. If any employee resigns from the company within the loan period, the employee should pay the balance and transferred the ownership to employee's name. By considering above factors it is not justifiable to identify this asset as PPE.
So it is better to account this transaction as financial assets, "loans & receivables" in accordance with the definitions in paragraph 9 of LKAS 39- Financial Instruments: Recognition and Measurement.
"Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market"

Paragraph 43 of this standard requires to measuring the financial assets ***initially at their fair value*** plus the transaction cost and subsequent measurement at amortized cost according to paragraph 46 (a).

"43- When a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability."

"46 (a) - loans and receivables as defined in paragraph 9, which shall be measured at amortized cost using the effective interest method"

Example:

Loan Granted Amount	100,000
Interest rate	0%
Market Interest rate	14%
Period	12Months
Installment	8,333
FV	92,812

At the time of granting

Loan A/c (At Fair Value)	Dr	92,812	
Other Asset	Dr	7,188	
Cash	Cr		100,000

The difference (7,188) between nominal amount of the loan (100,000) and loan's fair value (92,812) should be recognize as other asset and subsequently amortize during the loan period.

According to the standard periodically interest income also should be accounted even though it is not received in cash actually. Mean time the cost of such employee benefit should be accounted as the difference between:

- The interest income for the period based on the fair value of the loan asset (using effective interest method at the market rate of 14%); and
- The interest payable by the employee (at 0%)

At the time of first installment

Cash	Dr.	8,333	
Loan Account	Cr.		7,251
Interest Income	Cr.		1,083
P&L – Personal Cost	Dr.	1,083	
Other Asset	Cr		1,083

Loan amortization schedule

Opening Loan Balance	Installment	Capital Component	Interest on Loan	Closing Loan Balance
92,812	8,333	7,251	1,083	85,562
85,562	8,333	7,335	998	78,226
78,226	8,333	7,421	913	70,806
70,806	8,333	7,507	826	63,299
63,299	8,333	7,595	738	55,704
55,704	8,333	7,683	650	48,020
48,020	8,333	7,773	560	40,247
40,247	8,333	7,864	470	32,383
32,383	8,333	7,956	378	24,428
24,428	8,333	8,048	285	16,379
16,379	8,333	8,142	191	8,237
8,237	8,333	8,237	96	0
			7,188	