The following details relate to the plan in the year to 31 October 20X7:

	$m
Present value of obligation at 1 November 20X6	200
Present value of obligation at 31 October 20X7	240
Fair value of plan assets at 1 November 20X6	190
Fair value of plan assets at 31 October 20X7	225
Current service cost	20
Pension benefits paid	19
Total contributions paid to the scheme for year to 31 October 20X7	17

Remeasurement gains and losses are recognised in accordance with IAS 19.

Assume that contributions are paid into the plan and pension benefits are withdrawn from the plan on 31 October 20X7.

Joydan Pension Plan B

Under the terms of the plan, Joydan does not guarantee any return on the contributions paid into the fund. The company's legal and constructive obligation is limited to the amount that is contributed to the fund. The following details relate to this scheme:

	$m
Fair value of plan assets at 31 October 20X7	21
Contributions paid by company for year to 31 October 20X7	10
Contributions paid by employees for year to 31 October 20X7	10

The interest rate on high quality corporate bonds for the two plans are:

1 November 20X6	*31 October 20X7*
5%	6%

The company would like advice on how to treat the two pension plans, for the year ended 31 October 20X7, together with an explanation of the differences between a defined contribution plan and a defined benefit plan.

Required

Prepare a briefing note for the directors of Joydan which includes:

(i) An explanation of the nature of and differences between a defined contribution plan and a defined benefit plan with specific reference to the company's two schemes. **(8 marks)**

(ii) The accounting treatment for the two Joydan pension plans for the year ended 31 October 20X7 under IAS 19 *Employee Benefits*. **(9 marks)**

(b) **William**

William operates a defined benefit pension plan for its employees. Shortly before the year end of 31 May 20X3, William decided to relocate a division from one country to another, where labour and raw material costs are cheaper. The relocation is due to take place in December 20X3. On 13 May 20X3, a detailed formal plan was approved by the board of directors. Half of the affected division's employees will be made redundant in July 20X3, and will accrue no further benefits under William's defined benefit pension plan. The affected employees were informed of this decision on 14 May 20X3. The resulting reduction in the net pension liability due the relocation is estimated to have a present value of $15 million as at 31 May 20X3. Total relocation costs (excluding the impact on the pension plan) are estimated at $50 million.

Required

Advise the directors of William on how to account for the relocation costs and the reduction in the net pension liability for the year ended 31 May 20X3. **(8 marks)**

(Total = 25 marks)

55 Emcee **49 mins**

P2 Mar/Jun 2016 (amended)

Emcee, a public limited company, is a sports organisation which owns several football and basketball teams. It has a financial year end of 31 May 20X6.

(a) Emcee needs a new stadium to host sporting events which will be included as part of Emcee's property, plant and equipment. Emcee commenced construction of a new stadium on 1 February 20X6, and this continued until its completion which was after the year end of 31 May 20X6. The direct costs were $20 million in February 20X6 and then $50 million in each month until the year end. Emcee has not taken out any specific borrowings to finance the construction of the stadium, but it has incurred finance costs on its general borrowings during the period, which could have been avoided if the stadium had not been constructed. Emcee has calculated that the weighted average cost of borrowings for the period 1 February to 31 May 20X6 on an annualised basis amounted to 9% per annum. Emcee needs advice on how to treat the borrowing costs in its financial statements for the year ended 31 May 20X6. **(6 marks)**

(b) Emcee purchases and sells players' registrations on a regular basis. Emcee must purchase registrations for that player to play for the club. Player registrations are contractual obligations between the player and Emcee. The costs of acquiring player registrations include transfer fees, league levy fees, and player agents' fees incurred by the club. Often players' former clubs are paid amounts which are contingent upon the performance of the player whilst they play for Emcee. For example, if a contracted basketball player scores an average of more than 20 points per game in a season, then an additional $5 million may become payable to his former club. Also, players' contracts can be extended and this incurs additional costs for Emcee.

At the end of every season, which also is the financial year end of Emcee, the club reviews its playing staff and makes decisions as to whether they wish to sell any players' registrations. These registrations are actively marketed by circulating other clubs with a list of players' registrations and their estimated selling price. Players' registrations are also sold during the season, often with performance conditions attached. Occasionally, it becomes clear that a player will not play for the club again because of, for example, a player sustaining a career threatening injury or being permanently removed from the playing squad for another reason. The playing registrations of certain players were sold after the year end, for total proceeds, net of associated costs, of $25 million. These registrations had a net book value of $7 million.

Emcee would like to know the financial reporting treatment of the acquisition, extension, review and sale of players' registrations in the circumstances outlined above. **(11 marks)**

(c) Emcee uses the revaluation model to measure its stadiums. The directors have been offered $100 million from an airline for the property naming rights of all the stadiums for three years. There are two directors who are on the management boards of Emcee and the airline. Additionally, there are regulations in place by both the football and basketball leagues which regulate the financing of the clubs. These regulations prevent capital contributions from a related party which 'increases equity without repayment in return'. The aim of these regulations is to promote sustainable business models. Sanctions imposed by the regulator include fines and withholding of prize monies. Emcee wishes to know how to take account of the naming rights in the valuation of the stadium and the potential implications of the financial regulations imposed by the leagues. **(8 marks)**

Required

Discuss how the above events would be shown in the financial statements of Emcee under IFRS Standards.

Note. The mark allocation is shown against each of the three issues above.

(Total = 25 marks)

56 Estoil **49 mins**

P2 December 2014 (amended)

(a) An assessment of accounting practices for asset impairments is especially important in the context of financial reporting quality in that it requires the exercise of considerable management judgement and reporting discretion. The importance of this issue is heightened during periods of ongoing economic uncertainty as a result of the need for companies to reflect the loss of economic value in a timely fashion through the mechanism of asset write-downs. There are many factors which can affect the quality of impairment accounting and disclosures. These factors include changes in circumstance in the reporting period, the market capitalisation of the entity, the allocation of goodwill to cash-generating units, valuation issues and the nature of the disclosures.

Required

Discuss the importance and significance of the above factors when conducting an impairment test under IAS 36 *Impairment of Assets.* **(15 marks)**

(b) (i) Estoil is an international company providing parts for the automotive industry. It operates in many different jurisdictions with different currencies. During 20X4, Estoil experienced financial difficulties marked by a decline in revenue, a reorganisation and restructuring of the business and it reported a loss for the year. An impairment test of goodwill was performed but no impairment was recognised. Estoil applied one discount rate to all cash flows for all cash-generating units (CGUs), irrespective of the currency in which the cash flows would be generated. The discount rate used was the weighted average cost of capital (WACC) and Estoil used the ten-year government bond rate for its jurisdiction as the risk-free rate in this calculation. Additionally, Estoil built its model using a forecast denominated in the functional currency of the parent company. Estoil felt that any other approach would require a level of detail which was unrealistic and impracticable. Estoil argued that the different CGUs represented different risk profiles in the short term, but over a longer business cycle, there was no basis for claiming that their risk profiles were different.

(ii) Fariole specialises in the communications sector with three main CGUs. Goodwill was a significant component of total assets. Fariole performed an impairment test of the CGUs. The cash flow projections were based on the most recent financial budgets approved by management. The realised cash flows for the CGUs were negative in 20X4 and far below budgeted cash flows for that period. The directors had significantly raised cash flow forecasts for 20X5 with little justification. The projected cash flows were calculated by adding back depreciation charges to the budgeted result for the period with expected changes in working capital and capital expenditure not taken into account.

Required

Discuss the acceptability of the above accounting practices under IAS 36 *Impairment of Assets.* **(10 marks)**

(Total = 25 marks)

57 Evolve **49 mins**

P2 Sep/Dec 2016 (amended)

(a) Evolve is a real estate company, which is listed on the stock exchange and has a year end of 31 August. On 21 August 20X6, Evolve undertook a scrip (bonus) issue where the shareholders of Evolve received certain rights. The shareholders are able to choose between:

(i) Receiving newly issued shares of Evolve, which could be traded on 30 September 20X6; or

(ii) Transferring their rights back to Evolve by 10 September 20X6 for a fixed cash price which would be paid on 20 September 20X6.

In the financial statements at 31 August 20X6, Evolve believed that the criteria for the recognition of a financial liability as regards the second option were not met at 31 August 20X6 because it was impossible to reliably determine the full amount to be paid, until 10 September 20X6. Evolve felt that the transferring of the rights back to Evolve was a put option on its own equity, which would lead to recording changes in fair value in profit or loss in the next financial year. Evolve disclosed the transaction as a non-adjusting event after the reporting period. **(9 marks)**

(b) At 31 August 20X6, Evolve controlled a wholly owned subsidiary, Resource, whose only assets were land and buildings, which were all measured in accordance with IFRS Standards. On 1 August 20X6, Evolve published a statement stating that a binding offer for the sale of Resource had been made and accepted and, at that date, the sale was expected to be completed by 31 August 20X6. The non-current assets of Resource were measured at the lower of their carrying amount or fair value less costs to sell at 31 August 20X6, based on the selling price in the binding offer. This measurement was in accordance with IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations*. However, Evolve did not classify the non-current assets of Resource as held for sale in the financial statements at 31 August 20X6 because there were uncertainties regarding the negotiations with the buyer and a risk that the agreement would not be finalised. There was no disclosure of these uncertainties and the original agreement was finalised on 20 September 20X6. **(10 marks)**

(c) Evolve operates in a jurisdiction with a specific tax regime for listed real estate companies. Upon adoption of this tax regime, the entity has to pay a single tax payment based on the unrealised gains of its investment properties. Evolve purchased Monk whose only asset was an investment property for $10 million. The purchase price of Monk was below the market value of the investment property, which was $14 million, and Evolve chose to account for the investment property under the cost model. However, Evolve considered that the transaction constituted a 'bargain purchase' under IFRS 3 *Business Combinations*. As a result, Evolve accounted for the potential gain of $4 million in profit or loss and increased the 'cost' of the investment property to $14 million. At the same time, Evolve opted for the specific tax regime for the newly acquired investment property and agreed to pay the corresponding tax of $1 million. Evolve considered that the tax payment qualifies as an expenditure necessary to bring the property to the condition necessary for its operations, and therefore was directly attributable to the acquisition of the property. Hence, the tax payment was capitalised and the value of the investment property was stated at $15 million. **(6 marks)**

Required

Advise Evolve on how the above transactions should be correctly dealt with in its financial statements with reference to relevant IFRS Standards.

Note. The mark allocation is shown against each of the three issues above.

(Total = 25 marks)

58 Gasnature — 49 mins

P2 Sep/Dec 2015 (amended)

(a) Gasnature is a publicly traded entity involved in the production and trading of natural gas and oil. Gasnature jointly owns an underground storage facility with another entity, Gogas. Both parties extract gas from offshore gas fields, which they own and operate independently from each other. Gasnature owns 55% of the underground facility and Gogas owns 45%. They have agreed to share services and costs accordingly, with decisions regarding the storage facility requiring unanimous agreement of the parties. The underground facility is pressurised so that the gas is pushed out when extracted. When the gas pressure is reduced to a certain level, the remaining gas is irrecoverable and remains in the underground storage facility until it is decommissioned. Local legislation requires the decommissioning of the storage facility at the end of its useful life. Gasnature wishes to know how to treat the agreement with Gogas including any obligation or possible obligation arising on the underground storage facility and the accounting for the irrecoverable gas. **(9 marks)**

(b) Gasnature has entered into a ten-year contract with Agas for the purchase of natural gas. Gasnature has made an advance payment to Agas for an amount equal to the total quantity of gas contracted for ten years which has been calculated using the forecasted price of gas. The advance carries interest of 6% per annum, which is settled by way of the supply of extra gas. Fixed quantities of gas have to be supplied each month and there is a price adjustment mechanism in the contract whereby the difference between the forecasted price of gas and the prevailing market price is settled in cash monthly. If Agas does not deliver gas as agreed, Gasnature has the right to claim compensation at the current market price of gas. Gasnature wishes to know whether the contract with Agas should be accounted for under IFRS 9 *Financial Instruments*. **(6 marks)**

(c) Additionally, Gasnature is finalising its financial statements for the year ended 31 August 20X5 and has the following issues.

(i) Gasnature purchased a major refinery on 1 January 20X5 and the directors estimate that a major overhaul is required every two years. The costs of the overhaul are approximately $5 million which comprises $3 million for parts and equipment and $2 million for labour. The directors proposed to accrue the cost of the overhaul over the two years of operations up to that date and create a provision for the expenditure. **(5 marks)**

(ii) From October 20X4, Gasnature had undertaken exploratory drilling to find gas and up to 31 August 20X5 costs of $5 million had been incurred. At 31 August 20X5, the results to date indicated that it was probable that there were sufficient economic benefits to carry on drilling and there were no indicators of impairment. During September 20X5, additional drilling costs of $2 million were incurred and there was significant evidence that no commercial deposits existed and the drilling was abandoned. **(5 marks)**

Required

Discuss, with reference to IFRS Standards, how Gasnature should account for the above agreement and contract, and the issues raised by the directors

Note. The mark allocation is shown against each of the items above.

(Total = 25 marks)

59 Complexity 49 mins

Part (a) adapted from P2 December 2009

(a) Complexity borrowed $47 million on 1 December 20X4 when the market and effective interest rate was 5%. On 30 November 20X5, the company borrowed an additional $45 million when the current market and effective interest rate was 7.4%. Both financial liabilities are repayable on 30 November 20X9 and are single payment notes, whereby interest and capital are repaid on that date.

Complexity's creditworthiness has been worsening. It has entered into an interest rate swap agreement which acts as a hedge against a $2 million 2% bond issue which matures on 31 May 20X6. The directors of Complexity wish to know in which circumstances it can use hedge accounting. In particular, they need advice on hedge effectiveness and whether this can be calculated.

Required

(i) Discuss the accounting for the financial liabilities under IFRS 9 under the amortised cost method, and additionally using the fair value method as at 30 November 20X5. **(6 marks)**

(ii) Advise Complexity's directors as to the circumstances in which it can use hedge accounting and whether it can calculate hedge effectiveness. **(9 marks)**

(b) The type and value of financial instruments that Complexity holds has increased in recent years which has resulted in increased disclosures regarding financial instruments in the financial statements. Complexity's reporting accountant is concerned that the users of the financial statements find financial instruments complicated and has argued that there is no point in providing detailed information in this area as the users will not understand the disclosures.

Required

(i) Discuss, from the perspective of the users of financial statements, how the measurement of financial instruments under IFRS Standards can create confusion.

(6 marks)

(ii) Discuss the reporting accountant's view that detailed disclosures in respect of financial instruments do not provide useful information to the users of financial statements.

(4 marks)

(Total = 25 marks)

60 Carsoon — 49 mins

P2 Mar/Jun 2017 (amended)

Carsoon Co is a company which manufactures and retails motor vehicles. It also constructs premises for third parties. It has a year end of 28 February 20X7.

(a) The entity enters into lease agreements with the public for its motor vehicles. The agreements are normally for a three-year period. The customer decides how to use the vehicle within certain contractual limitations. The maximum mileage per annum is specified at 10,000 miles without penalty. Carsoon is responsible for the maintenance of the vehicle and insists that the vehicle cannot be modified in any way. At the end of the three-year contract, the customer can purchase the vehicle at a price which will be above the market value, or alternatively hand it back to Carsoon. If the vehicle is returned, Carsoon will then sell the vehicle on to the public through one of its retail outlets. These sales of vehicles are treated as investing activities in the statement of cash flows.

The directors of Carsoon wish to know how the leased vehicles should be accounted for, from the commencement of the lease to the final sale of the vehicle, in the financial statements including the statement of cash flows. **(9 marks)**

(b) On 1 March 20X6, Carsoon invested in a debt instrument with a fair value of $6 million and has assessed that the financial asset is aligned with the fair value through other comprehensive income business model. The instrument has an interest rate of 4% over a period of six years. The effective interest rate is also 4%. On 1 March 20X6, the debt instrument is not impaired in any way. During the year to 28 February 20X7, there was a change in interest rates and the fair value of the instrument seemed to be affected. The instrument was quoted in an active market at $5.3 million but the price based upon an in-house model showed that the fair value of the instrument was $5.5 million. This valuation was based upon the average change in value of a range of instruments across a number of jurisdictions.

The directors of Carsoon felt that the instrument should be valued at $5.5 million and that this should be shown as a Level 1 measurement under IFRS 13 *Fair Value Measurement*. There has not been a significant increase in credit risk since 1 March 20X6, and expected credit losses should be measured at an amount equal to 12-month expected credit losses of $400,000. Carsoon sold the debt instrument on 1 March 20X7 for $5.3 million.

The directors of Carsoon wish to know how to account for the debt instrument until its sale on 1 March 20X7. **(8 marks)**

(c) Carsoon constructs retail vehicle outlets and enters into contracts with customers to construct buildings on their land. The contracts have standard terms, which include penalties payable by Carsoon if the contract is delayed, or payable by the customer, if Carsoon cannot gain access to the construction site.

Due to poor weather, one of the projects was delayed. As a result, Carsoon faced additional costs and contractual penalties. As Carsoon could not gain access to the construction site, the directors decided to make a counterclaim against the customer for the penalties and additional costs which Carsoon faced. Carsoon felt that because a counter claim had been made against the customer, the additional costs and penalties should not be included in contract costs but shown as a contingent liability. Carsoon has assessed the legal basis of the claim and feels it has enforceable rights.

In the year ended 28 February 20X7, Carsoon incurred general and administrative costs of $10 million, and costs relating to wasted materials of $5 million.

Additionally, during the year, Carsoon agreed to construct a storage facility on the same customer's land for $7 million at a cost of $5 million. The parties agreed to modify the contract to include the construction of the storage facility, which was completed during the current financial year. All of the additional costs relating to the above were capitalised as assets in the financial statements.

The directors of Carsoon wish to know how to account for the penalties, counter claim and additional costs in accordance with IFRS 15 *Revenue from Contracts with Customers*.

(8 marks)

Required

Advise Carsoon on how the above transactions should be dealt with in its financial statements with reference to relevant IFRS Standards.

Note. The mark allocation is shown against each of the three issues above.

(Total = 25 marks)

61 Leigh — 49 mins

ACR June 2007 (amended)

(a) Leigh, a public limited company, purchased the whole of the share capital of Hash, a limited company, on 1 June 20X6. The whole of the share capital of Hash was formerly owned by the five directors of Hash and under the terms of the purchase agreement, the five directors were to receive a total of three million ordinary shares of $1 of Leigh on 1 June 20X6 (market value $6 million) and a further 5,000 shares per director on 31 May 20X7, if they were still employed by Leigh on that date. All of the directors were still employed by Leigh at 31 May 20X7.

Leigh granted and issued fully paid shares to its own employees on 31 May 20X7. Normally share options issued to employees would vest over a three-year period, but these shares were given as a bonus because of the company's exceptional performance over the period. The shares in Leigh had a market value of $3 million (one million ordinary shares of $1 at $3 per share) on 31 May 20X7 and an average fair value of $2.5 million (one million ordinary shares of $1 at $2.50 per share) for the year ended 31 May 20X7. It is expected that Leigh's share price will rise to $6 per share over the next three years. **(10 marks)**

(b) On 31 May 20X7, Leigh purchased property, plant and equipment for $4 million. The supplier has agreed to accept payment for the property, plant and equipment either in cash or in shares. The supplier can either choose 1.5 million shares of Leigh to be issued in six months' time or to receive a cash payment in three months' time equivalent to the market value of 1.3 million shares. It is estimated that the share price will be $3.50 in three months' time and $4 in six months' time.

Additionally, at 31 May 20X7, one of the directors recently appointed to the board has been granted the right to choose either 50,000 shares of Leigh or receive a cash payment equal to the current value of 40,000 shares at the settlement date. This right has been granted because of the performance of the director during the year and is unconditional at 31 May 20X7. The settlement date is 1 July 20X8 and the company estimates the fair value of the share alternative is $2.50 per share at 31 May 20X7. The share price of Leigh at 31 May 20X7 is $3 per share, and if the director chooses the share alternative, they must be kept for a period of four years. **(9 marks)**

(c) Leigh acquired 30% of the ordinary share capital of Handy, a public limited company, on 1 April 20X6. The purchase consideration was one million ordinary shares of Leigh which had a market value of $2.50 per share at that date and the fair value of the net assets of Handy was $9 million. The retained earnings of Handy were $4 million and other reserves of Handy were $3 million at that date. Leigh appointed two directors to the Board of Handy, and it intends to hold the investment for a significant period of time. Leigh exerts significant influence over Handy. The summarised statement of financial position of Handy at 31 May 20X7 is as follows.

	$m
Share capital of $1	2
Other reserves	3
Retained earnings	5
	10
Net assets	10

There had been no new issues of shares by Handy since the acquisition by Leigh and the estimated recoverable amount of the net assets of Handy at 31 May 20X7 was $11 million. **(6 marks)**

Required

Discuss with suitable computations how the above share-based transactions should be accounted for in the financial statements of Leigh for the year ended 31 May 20X7.

(Total = 25 marks)

62 Mehran — 49 mins

P2 March/June 2016 (amended)

The directors of Mehran, a public limited company, have seen many different ways of dealing with the measurement and disclosure of the fair value of assets, liabilities and equity instruments. They feel that this reduces comparability among different entities' financial statements. They would like advice on how IFRS 13 *Fair Value Measurement* should be applied to several transactions.

(a) Mehran has just acquired a company, which comprises a farming and mining business. Mehran wishes advice on how to place a fair value on some of the assets acquired.

One such asset is a piece of land, which is currently used for farming. The fair value of the land if used for farming is $5 million. If the land is used for farming purposes, a tax credit arises annually, which is based upon the lower of 15% of the fair market value of land or $500,000 at the current tax rate. The current tax rate in the jurisdiction is 20%.

Mehran has determined that market participants would consider that the land could have an alternative use for residential purposes. The fair value of the land for residential purposes before associated costs is thought to be $7.4 million. In order to transform the land from farming to residential use, there would be legal costs of $200,000, a viability analysis cost of $300,000 and costs of demolition of the farm buildings of $100,000. Additionally, permission for residential use has not been formally given by the legal authority and because of this, market participants have indicated that the fair value of the land, after the above costs, would be discounted by 20% because of the risk of not obtaining planning permission.

In addition, Mehran has acquired the brand name associated with the produce from the farm. Mehran has decided to discontinue the brand on the assumption that it will gain increased revenues from its own brands. Mehran has determined that if it ceases to use the brand, then the indirect benefits will be $20 million. If it continues to use the brand, then the direct benefit will be $17 million. **(7 marks)**

(b) Mehran wishes to place a fair value on the inventory of the entity acquired. There are three different markets for the produce, which are mainly vegetables. The first is the local domestic market where Mehran can sell direct to retailers of the produce. The second domestic market is one where Mehran sells directly to manufacturers of canned vegetables. There are no restrictions on the sale of produce in either of the domestic markets other than the demand of the retailers and manufacturers. The final market is the export market but the government limits the amount of produce which can be exported. Mehran needs a licence from the government to export its produce. Farmers tend to sell all of the produce that they can in the export market and, when they do not have any further authorisation to export, they sell the remaining produce in the two domestic markets.

It is difficult to obtain information on the volume of trade in the domestic market where the produce is sold locally direct to retailers but Mehran feels that the market is at least as large as the domestic market – direct to manufacturers. The volumes of sales quoted below have been taken from trade journals.

	Domestic market – direct to retailers	*Domestic market – direct to manufacturers*	*Export market*
Volume – annual	Unknown	20,000 tonnes	10,000 tonnes
Volume – sales per month	10 tonnes	4 tonnes	60 tonnes
Price per tonne	$1,000	$800	$1,200
Transport costs per tonne	$50	$70	$100
Selling agents' fees per tonne	–	$4	$6

(10 marks)

(c) Mehran owns a non-controlling equity interest in Erham, a private company, and wishes to measure the interest at its fair value at its financial year end of 31 March 20X6. Mehran acquired the ordinary share interest in Erham on 1 April 20X4. During the current financial year, Erham has issued further equity capital through the issue of preferred shares to a venture capital fund.

As a result of the preferred share issue, the venture capital fund now holds a controlling interest in Erham. The terms of the preferred shares, including the voting rights, are similar to those of the ordinary shares, except that the preferred shares have a cumulative fixed dividend entitlement for a period of four years and the preferred shares rank ahead of the ordinary shares upon the liquidation of Erham. The transaction price for the preferred shares was $15 per share.

Mehran wishes to know the factors which should be taken into account in measuring the fair value of their holding in the ordinary shares of Erham at 31 March 20X6 using a market-based approach. **(8 marks)**

Required

Discuss the way in which Mehran should measure the fair value the above assets with reference to the principles of IFRS 13 *Fair Value Measurement*.

Note. The mark allocation is shown against each of the three issues above.

(Total = 25 marks)

63 Ethan **49 mins**

P2 December 2012 (amended)

Ethan, a public limited company, develops, operates and sells investment properties.

(a) Ethan focuses mainly on acquiring properties where it foresees growth potential, through rental income as well as value appreciation. The acquisition of an investment property is usually realised through the acquisition of the entity, which holds the property.

In Ethan's consolidated financial statements, investment properties acquired through business combinations are recognised at fair value, using a discounted cash flow model as approximation to fair value. There is currently an active market for this type of property. The difference between the fair value of the investment property as determined under the accounting policy, and the value of the investment property for tax purposes results in a deferred tax liability.

Goodwill arising on business combinations is determined using the measurement principles for the investment properties as outlined above. Goodwill is only considered impaired if and when the deferred tax liability is reduced below the amount at which it was first recognised. This reduction can be caused both by a reduction in the value of the real estate or a change in local tax regulations. As long as the deferred tax liability is equal to, or larger than, the prior year, no impairment is charged to goodwill. Ethan explained its accounting treatment by confirming that almost all of its goodwill is due to the deferred tax liability and that it is normal in the industry to account for goodwill in this way.

Since 20X0, Ethan has incurred substantial annual losses except for the year ended 31 May 20X3, when it made a small profit before tax. In year ended 31 May 20X3, most of the profit consisted of income recognised on revaluation of investment properties. Ethan had announced early in its financial year ended 31 May 20X4 that it anticipated substantial growth and profit. Later in the year, however, Ethan announced that the expected profit would not be achieved and that, instead, a substantial loss would be incurred. Ethan had a history of reporting considerable negative variances from its budgeted results. Ethan's recognised deferred tax assets have been increasing year-on-year despite the deferred tax liabilities recognised on business combinations. Ethan's deferred tax assets consist primarily of unused tax losses that can be carried forward which are unlikely to be offset against anticipated future taxable profits. **(13 marks)**

(b) Ethan wishes to apply the fair value option rules of IFRS 9 *Financial Instruments* to debt issued to finance its investment properties. Ethan's argument for applying the fair value option is based upon the fact that the recognition of gains and losses on its investment properties and the related debt would otherwise be inconsistent. Ethan argued that there is a specific financial correlation between the factors, such as interest rates, that form the basis for determining the fair value of both Ethan's investment properties and the related debt. **(7 marks)**

(c) Ethan has an operating subsidiary, which has in issue A and B shares, both of which have voting rights. Ethan holds 70% of the A and B shares and the remainder are held by shareholders external to the group. The subsidiary is obliged to pay an annual dividend of 5% on the B shares. The dividend payment is cumulative even if the subsidiary does not have sufficient legally distributable profit at the time the payment is due.

In Ethan's consolidated statement of financial position, the B shares of the subsidiary were accounted for in the same way as equity instruments would be, with the B shares owned by external parties reported as a non-controlling interest. **(5 marks)**

Required

Discuss how the above transactions and events should be recorded in the consolidated financial statements of Ethan.

Note. The mark allocation is shown against each of the three transactions above.

(Total = 25 marks)

64 Whitebirk **43 mins**

P2 December 2010 (amended)

(a) The main argument for separate accounting standards for small and medium-sized entities is the undue cost burden of reporting, which is proportionately heavier for smaller firms.

Required

Discuss the main differences and modifications to IFRS which the IASB made when it published the *IFRS for Small and Medium-Sized Entities* (IFRS for SMEs), giving specific examples where possible and include in your discussion how the Board has dealt with the problem of defining an SME. **(11 marks)**

(b) Whitebirk has met the definition of a SME in its jurisdiction and wishes to comply with the IFRS for SMEs. The entity wishes to seek advice on how it will deal with the following accounting issues in its financial statements for the year ended 30 November 20X2. The entity already prepares its financial statements under full IFRS Standards.

(i) Whitebirk purchased 90% of Close, an SME, on 1 December 20X1. The purchase consideration was $5.7 million and the value of Close's identifiable assets was $6 million. Whitebirk has elected to measure the non-controlling interest at acquisition at its fair value of $0.7 million. The life of the goodwill cannot be estimated with any accuracy. Whitebirk wishes to know how to account for goodwill under the IFRS for SMEs.

(ii) Whitebirk has incurred $1 million of research expenditure to develop a new product in the year to 30 November 20X2. Additionally, it incurred $500,000 of development expenditure to bring another product to a stage where it is ready to be marketed and sold.

(iii) Whitebirk purchased some properties for $1.7 million on 1 December 20X1 and designated them as investment properties under the cost model. No depreciation was charged as a real estate agent valued the properties at $1.9 million at the year end.

(iv) Whitebirk has an intangible asset valued at $1 million on 1 December 20X1. The asset has an indefinite useful life, and in previous years had been reviewed for impairment. As at 30 November 20X2, there are no indications that the asset is impaired.

Required

Discuss how the above transactions should be dealt with in the financial statements of Whitebirk, with reference to the IFRS for SMEs. **(11 marks)**

(Total = 22 marks)

65 Revenue recognition **49 mins**

The exhibits below provide all the information required to answer the question.

Exhibit 1 - Warranties

Premier Co sold a machine to a customer for $196,000, which is the standalone selling price of the machine. The sales contract included a warranty that provides assurance that the machine complies with agreed-upon specifications and will operate as promised for one year from the date of purchase. As the customer represents new business to Premier Co, as an incentive to purchase the machine, Premier Co gave the customer an additional extended warranty, at no extra cost, which guarantees the machine will operate as expected for a further six month period after the standard warranty has elapsed. Six month extended warranties are normally charged at $4,000.

Exhibit 2 - Jewellery sales

Jae Co is a retailer of high-value items of diamond jewellery. A significant proportion of the items available for sale in Jae Co's stores were handmade by Rodia Co.

These items are held under a contractual arrangement with Rodia Co, the terms of which specify that Rodia Co retains the ability to change the selling price of the jewellery, and that Jae Co is required to return any unsold jewellery after a period of nine months. When Jae Co sells an item of jewellery to a customer, legal title to the jewellery passes from Rodia Co to the customer.

Jae Co has paid a significant deposit to Rodia Co in order to hold the jewellery in its stores. This deposit is deducted, on a proportionate basis, from the amount payable to Rodia Co when items are sold or is refunded in full if items are returned. Jae Co is not required to pay in full for the jewellery until it is sold on to a customer.

Exhibit 3 - Right to return sales

Kracker Co sold 100 identical items to a customer for $2,000 each. The items cost Kracker Co $1,600 each to manufacture. The terms of sale are that the customer has the right to return the goods for a full refund within three months. After the three-month period has expired the customer can no longer return the goods and payment becomes immediately due. Kracker Co has entered into transactions of this type with this customer previously and can reliably estimate that no more than 4% of the products are likely to be returned within the three-month period.

Exhibit 4 - Non-refundable fee

Kotta Co has started a community food store which sells food at heavily discounted prices to its members. To become a member, a customer must pay a non-refundable joining fee of $30. On payment of the fee, Kotta Co creates a unique account for the customer and provides the customer with a membership card. The customer can then access the community food store at any time during its opening hours, over a 12 month period. The customer pays for the food they purchase at the time of their visit to the food store.

Required

(a) Explain the accounting treatment required for each warranty provided by Premier Co and the revenue to be recognised by Premier Co for the sale of the machine in Exhibit 1. **(10 marks)**

(b) Explain how Jae Co and Rodia Co should account for sales under the contractual arrangement made between them as described in Exhibit 2. **(7 marks)**

(c) Explain how Kracker Co should account for the sales transaction described in Exhibit 3 at the date of the sale. You should include relevant journal entries in your answer. **(4 marks)**

(d) Explain how Kotta Co should account for the $30 non-refundable joining fee paid by its customers as described in Exhibit 4. **(4 marks)**

(Total = 25 marks)

66 Seltec — 49 mins

P2 June 2010 (amended)

Seltec, a public limited company, processes and sells edible oils and uses several financial instruments to spread the risk of fluctuation in the price of the edible oils. The entity operates in an environment where the transactions are normally denominated in dollars. The functional currency of Seltec is the dollar.

(a) The entity uses forward and futures contracts to protect it against fluctuation in the price of edible oils. Where forwards are used, the company often takes delivery of the edible oil and sells it shortly afterwards. The contracts are constructed with future delivery in mind but the contracts also allow net settlement in cash as an alternative. The net settlement is based on the change in the price of the oil since the start of the contract. Seltec uses the proceeds of a net settlement to purchase a different type of oil or purchase from a different supplier. Where futures are used these sometimes relate to edible oils of a different type and market than those of Seltec's own inventory of edible oil. The company intends to apply hedge accounting to these contracts in order to protect itself from earnings volatility. Seltec has also entered into a long-term arrangement to buy oil from a foreign entity whose currency is the dinar. The commitment stipulates that the fixed purchase price will be denominated in pounds sterling.

Seltec is unsure as to the nature of derivatives and hedge accounting techniques and has asked your advice on how the above financial instruments should be dealt with in the financial statements. **(15 marks)**

(b) Seltec has decided to enter the retail market and has recently purchased two well-known brand names in the edible oil industry. One of the brand names has been in existence for many years and has a good reputation for quality. The other brand name is named after a famous film star who has been actively promoting the edible oil as being a healthier option than other brands of oil. This type of oil has only been on the market for a short time. Seltec is finding it difficult to estimate the useful life of the brands and therefore intends to treat the brands as having indefinite lives.

In order to sell the oil, Seltec has purchased two limited liability companies from a company that owns several retail outlets. Each entity owns retail outlets in several shopping complexes. The only assets of each entity are the retail outlets. There is no operational activity and at present the entities have no employees.

Seltec is unclear as to how the purchase of the brands and the entities should be accounted for. **(10 marks)**

Required

Discuss the accounting principles involved in accounting for the above transactions and how the above transactions should be treated in the financial statements of Seltec.

Note. The mark allocation is shown against each of the two parts above.

(Total = 25 marks)

67 Della Co — 49 mins

Della Co has a 31 December reporting date. The following exhibits provide information relevant to the question.

Exhibit 1 – Sale of specialised product

On 30 November 20X0, Della Co sold a specialised product to a Cromer Co for $242,000 in cash on that date. Della Co has the right to cancel the sale and require the return of the product at any time up to and including 31 January 20X1. If Della Co cancels the sale, it must refund Cromer Co the original $242,000 plus $500.

Exhibit 2 - Agreement with Acra Co

Della Co has a contractual agreement with Acra Co, whereby Acra Co holds items of Della Co's product X in its stores for a trial period of 6 months from 1 September 20X1. The items cost $45,000 and have a retail value of $63,000.

Della Co retains the right to set the selling price of the product X. When Acra Co sells one of the items to a customer, legal title passes from Della Co to the customer. At the end of each month, Acra Co must remit amounts to Della Co for items of product X that have been sold.

Acra Co has paid a refundable deposit to hold product X in its stores. The deposit is deducted by Acra Co, on a proportionate basis, from the amounts remitted to Della Co each month. At the end of the trial period Acra Co is required to return any unsold product X to Della Co in return for any remaining deposit.

Exhibit 3 - Hedging arrangement

On 1 January 20X0, Della Co invested in $2 million in 6% bonds, redeemable in 20X9 with a nominal value of £2m. Della Co accounts for the investment at fair value through other comprehensive income. By 31 December 20X0, the fair value of the bonds had increased to $2.5m.

On 1 January 20X1, Della Co decided to protect against the risk of changes in the fair value of the bond caused by future interest rate increases. As a result, on that date it entered into a five-year interest rate swap, in which it would pay a fixed rate and receive a variable rate. The fair value of the swap at inception was nil.

On 31 December 20X1, the fair value of the government bonds had fallen to $1.9m. The fair value of the swap at that date was $0.55m. Della Co is unsure as to hedge accounting techniques and has asked your advice on how the above financial instruments should be dealt with in the financial statements.

Required

(a) Discuss how the sale of the specialised product on 30 November 20X1 should be accounted for in the financial statements of Della Co. **(7 marks)**

(b) Discuss how the contractual agreement with Acra Co should be accounted for in the financial statements of Della Co. **(7 marks)**

(c) Discuss briefly the requirements for hedge accounting under IFRS 9 *Financial Instruments* and explain how the bonds and the interest rate swap should be accounted for in the financial statements of Della Co at 31 December 20X0 and at 31 December 20X1.

(8 marks)

(Total = 25 marks)

Answer Bank

Section 1 – Preparation questions

1 Financial instruments

(a) STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	$
Finance income	
(441,014 × (W1) 8%)	35,281

STATEMENT OF FINANCIAL POSITION

Non-current assets	
Financial asset (441,014 + 35,281)	476,295

Working: Effective interest rate

$\frac{600,000}{441,014} = 1.3605$ ∴ from tables interest rate is 8%

(b) **Compound instrument**

	$
Presentation	
Non-current liabilities	
Financial liability component of convertible bond (Working)	1,797,467
Equity	
Equity component of convertible bond (2,000,000 – (Working) 1,797,467)	202,533

Working: Fair value of equivalent non-convertible debt

	$
Present value of principal payable at end of 3 years $(4,000 \times \$500 = \$2m \times \frac{1}{(1.09)^3})$	1,544,367
Present value of interest annuity payable annually in arrears for 3 years [(5% × $2m) × 2.531]	253,100
	1,797,467

2 Leases

(a) **Interest rate implicit in the lease**

PV = annuity × cumulative discount factor (CDF)

250,000 = 78,864 × CDF

$\therefore \text{CDF} = \frac{250,000}{78,864}$

$= 3.170$

∴ Interest rate is 10%

(b) At the inception of the lease, Sugar Co recognises a right-of-use asset and a lease liability. The right-of-use asset is measured at the amount of the lease liability, which is the present value of the future lease payments discounted at the rate of interest implicit in the lease, here $250,000. At 31 December, the right-of-use asset is measured at cost less accumulated depreciation: $250,000 – $(250,000/4) = $187,500. The lease liability is measured by increasing the carrying amount to reflect interest on the lease liability and reducing the carrying amount to reflect the lease payments made.

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X1 (EXTRACT)

Property, plant and equipment	$
Right-of-use asset	187,500
Non-current liabilities	
Lease liabilities (W)	136,886
Current liabilities	
Lease liabilities (W) (196,136 – 136,886)	59,250

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 DECEMBER 20X1 (EXTRACT) (PROFIT OR LOSS SECTION)

Depreciation on right-of-use asset	62,500
Finance charges	25,000

Working: Lease liability

		$
Year ended 31 December 20X1:		
1.1.X1	Liability b/d	250,000
1.1.X1 – 31.12.X1	Interest at 10%	25,000
31.12.X1	Instalment in arrears	(78,864)
31.12.X1	Liability c/d	196,136
Year ended 31 December 20X2:		
1.1.X2 – 31.12.X2	Interest at 10%	19,614
31.12.X2	Instalment in arrears	(78,864)
31.12.X2	Liability c/d	136,886

3 Defined benefit plan

NOTES TO THE STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Defined benefit expense recognised in profit or loss

	$m
Current service cost	11
Past service cost	10
Net interest on the net defined benefit asset (10% × (110 + 10)) – (10% × 150)	(3)
	18

Other comprehensive income (items that will not be reclassified to profit or loss)

Remeasurement of defined benefit plans

	$m
Remeasurement gain on defined benefit obligation	17
Remeasurement loss on plan assets	(22)
	(5)

NOTES TO THE STATEMENT OF FINANCIAL POSITION

Net defined benefit asset recognised in the statement of financial position

	31 December 20X1	*31 December 20X0*
	$m	$m
Present value of pension obligation	116	110
Fair value of plan assets	(140)	(150)
Net asset	(24)	(40)

Changes in the present value of the defined benefit obligation

	$m
Opening defined benefit obligation	110
Interest on obligation (10% × (110 + 10))	12
Current service cost	11
Past service cost	10
Benefits paid	(10)
Gain on remeasurement through OCI (balancing figure)	(17)
Closing defined benefit obligation	116

Changes in the fair value of plan assets

	$m
Opening fair value of plan assets	150
Interest on plan assets (10% × 150)	15
Contributions	7
Benefits paid	(10)
Loss on remeasurement through OCI (balancing figure)	(22)
Closing fair value of plan assets	140

Tutorial note.

The interest on the defined benefit obligation is calculated on the balance at the start of the year ($110 million) plus the increase in obligation of $10 million due to past service costs. Interest is charged on the increase in obligation due to past service costs because the $10 million given in the question is the present value at the start of the year (if it were the present value at the end of the year, no interest would be required).

4 Sundry standards

Workbook reference. Employee benefits are covered in Chapter 5 of the SBR Workbook, embedded derivatives in covered in Chapter 8.

(a) NOTES TO THE STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Defined benefit expense recognised in profit or loss

	$'000
Current service cost	275
Net interest on the net defined benefit liability (318 – 306)	12
Curtailment cost	58
	345

Other comprehensive income (items that will not be reclassified to profit or loss)

Remeasurement of defined benefit plans

	$'000
Remeasurement loss on defined benefit obligation	(19)
Remeasurement gain on plan assets	89
	70

NOTES TO THE STATEMENT OF FINANCIAL POSITION

Net defined benefit liability recognised in the statement of financial position

	31 January 20X8	*31 January 20X7*
	$m	$'000
Present value of pension obligation	4,640	4,300
Fair value of plan assets	(4,215)	(3,600)
Net liability	425	700

Changes in the present value of the defined benefit obligation

	$'000
Opening defined benefit obligation	4,300
Benefits paid	(330)
Interest on obligation (4,300 – 330) × 8%	318
Curtailment	58
Current service cost	275
Loss on remeasurement through OCI (balancing figure)	19
Closing defined benefit obligation	4,640

Changes in the fair value of plan assets

	$'000
Opening fair value of plan assets	3,600
Contributions	550
Benefits paid	(330)
Interest on plan assets ((3,600 + 550 – 330) × 8%)	306
Gain on remeasurement through OCI (balancing figure)	89
Closing fair value of plan assets	4,215

(b) **Settlement**

(i) *Calculation of net defined benefit liability*

Changes in the present value of the defined benefit obligation 20X8

	$'000
Opening defined benefit obligation (1.1.X8)	40,000
Interest on obligation (40,000 × 8%)	3,200
Current service cost	2,500
Past service cost	2,000
Benefits paid	(1,974)
	45,726
Loss on remeasurement through OCI (bal. fig.)	274
Closing defined benefit obligation (31.12.X8)	46,000

20X9

	$'000
Opening defined benefit obligation (1.1.X9)	46,000
Interest on obligation (46,000 × 9%)	4,140
Current service cost	2,860
Settlement	(11,400)
Benefits paid	(2,200)
	39,400
Loss on remeasurement through OCI (bal. fig.)	1,400
Closing defined benefit obligation (31.12.X9)	40,800

Changes in the fair value of plan assets
20X8

	$'000
Opening fair value of plan assets (1.1.X8)	40,000
Interest on plan assets (40,000 × 8%)	3,200
Benefits paid	(1,974)
Contributions paid	2,000
	43,226
Loss on remeasurement through OCI (bal. fig.)	(226)
Closing fair value of plan assets (31.12.X8)	43,000

	$'000
Opening fair value of plant assets (1.1.X9)	43,000
Interest on plan assets (43,000 × 9%)	3,870
Settlement	(10,800)
Benefits paid	(2,200)
Contributions paid in	2,200
	36,070
Loss on remeasurement through OCI (bal. fig.)	(390)
Closing fair value of plan assets (31.12.X9)	35,680

- During 20X8, there is an improvement in the future benefits available under the plan and as a result there is a past service cost of $2 million, being the increase in the present value of the obligation as a result of the change.
- During 20X9, Sion sells part of its operations and transfers the relevant part of the pension plan to the purchaser. This is a settlement. The overall gain on settlement is calculated as:

	$'000
Present value of obligation settled	11,400
Fair value of plan assets transferred on settlement	(10,800)
Cash transferred on settlement	(400)
Gain	200

(ii) *Financial statements extracts*

STATEMENT OF FINANCIAL POSITION

	20X8 $'000	*20X9* $'000
Net defined benefit liability: (46,000 – 43,000)/(40,800 – 35,680)	3,000	5,120

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	20X8 $'000	*20X9* $'000
Profit or loss		
Current service cost	2,500	2,860
Past service cost	2,000	–
Gain on settlement	–	(200)
Net interest: (3,200 – 3,200)/(4,140 – 3,870)	–	270
Other comprehensive income		
Remeasurement loss on defined benefit pension plan: (274 + 226)/(1,400 + 390)	500	1,790

(c) **Classification of financial assets**

Bed's deposit is a **financial asset**. According to IFRS 9 *Financial Instruments*, financial assets are classified as measured at either **amortised cost or fair value.**

A financial asset is measured at **amortised cost** where:

(i) The asset is held within a **business model** where the objective is to hold financial assets in order to **collect contractual cash flows**; and

(ii) The contractual terms of the financial asset give rise on specified dates to **cash flows that are solely payments of principal and interest** on the principal amount outstanding.

All other financial assets are measured at fair value.

Deposit with Em Bank

At first glance, it appears that this deposit **may meet the criteria to be measured at amortised cost** because Bed will receive cash flows comprising the principal amount ($10 million) and interest (2.5%). However, IFRS 9 requires the **cash flows to be consistent with a basic lending arrangement**, where the **time value of money and credit risk** are typically the most significant elements of interest. **Contractual terms** that **introduce exposure to risk or volatility in the contractual cash flows** that is **unrelated** to a basic lending arrangement, such as exposure to changes in exchange rates, **do not give rise to contractual cash flows that are solely payments of principal and interest.**

The **additional 3% interest** Bed will receive if the exchange rate target is reached, exposes Bed to **risk in cash flows** that are **unrelated to a basic lending arrangement** (movement in exchange rates). Therefore, the contract with Em Bank does not give rise to contractual cash flows that are purely payments of principal and interest and as a result, it should not be measured at amortised cost. This type of contract is referred to as a 'hybrid contract'.

This **additional 3%** dependent on exchange rates is an **embedded derivative.** Derivatives embedded within a **host** which is a **financial asset** within the scope of IFRS 9 are **not separated out** for accounting purposes. Instead, the **usual IFRS 9 measurement** requirements should be applied to the entire hybrid contract.

Since the **contract with Em Bank** does **not** meet the criteria to be measured at **amortised cost**, the **entire contract** (including the term entitling Bed to an additional 3% if the exchange rate target is met) should be **measured at fair value through profit or loss.**

5 Control

(a) IFRS 10 states that an investor **controls** an investee if and only if it has all of the following.

(1) **Power** over the investee;

(2) Exposure, or rights, to **variable returns** from its involvement with the investee; and

(3) The **ability to use its power** over the investee to affect the amount of the investor's returns.

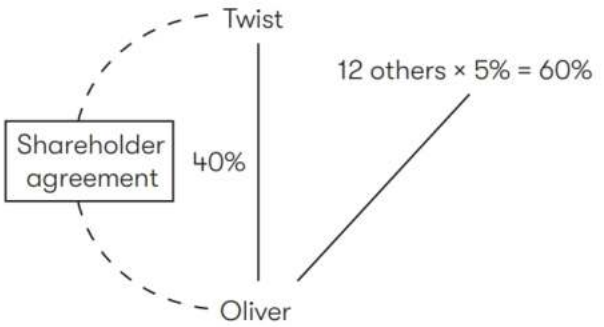
Power is defined as **existing rights that give the current ability to direct the relevant activities of the investee.** There is no requirement for that power to have been exercised.

Relevant activities may include:

- Selling and purchasing goods or services
- Managing financial assets
- Selecting, acquiring and disposing of assets
- Researching and developing new products and processes
- Determining a funding structure or obtaining funding

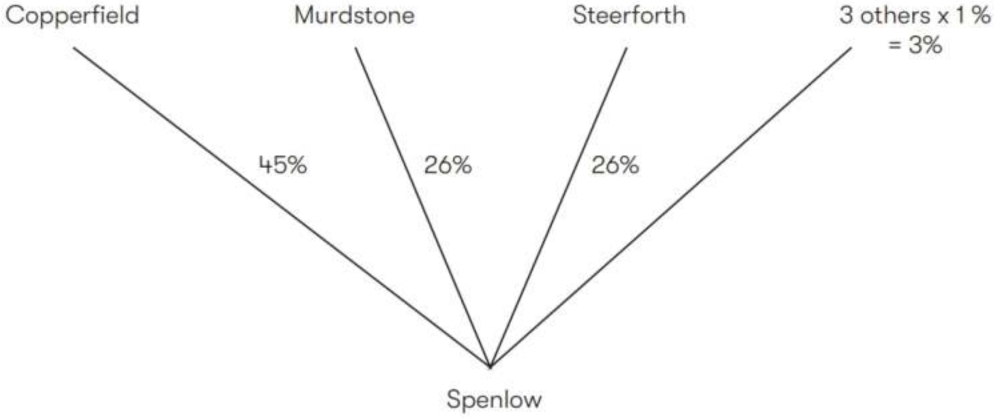
In some cases assessing power is straightforward, for example, where power is obtained directly and solely from having the majority of voting rights or potential voting rights, and as a result the ability to direct relevant activities.

(b)



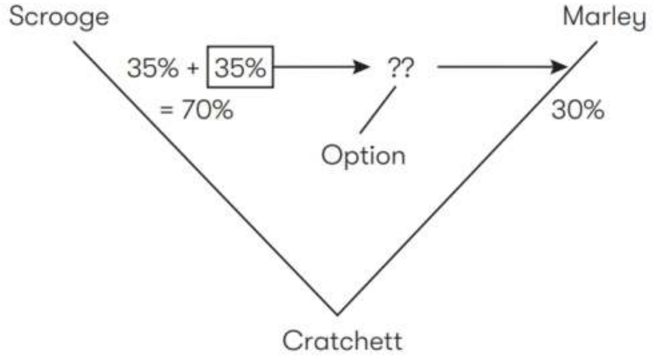
The absolute size of Twist's holding and the relative size of the other shareholdings alone are not conclusive in determining whether the investor has rights sufficient to give it power. However, the fact that Twist has **a contractual right to appoint, remove and set the remuneration of management** is sufficient to conclude that it **has power over Oliver.** The fact that Twist has not exercised this right is not a determining factor when assessing whether Twist has power. In conclusion, Twist does control Oliver, and should consolidate it.

(c)



In this case, the size of Copperfield's voting interest and its size relative to the other shareholdings are sufficient to conclude that Copperfield **does not have power**. Only two other investors, Murdstone and Steerforth, would need to co-operate to be able to prevent Copperfield from directing the relevant activities of Spenlow.

(d)



Scrooge holds a majority of the current voting rights of Cratchett, so is likely to meet the power criterion because it appears to have the current ability to direct the relevant activities. Although Marley has currently exercisable options to purchase additional voting rights (that, if exercised, would give it a majority of the voting rights in Cratchett), the terms and conditions associated with those options are such that the options are not considered substantive.

Thus voting rights, even combined with potential voting rights, may not be the deciding factor. Scrooge should consolidate Cratchett.

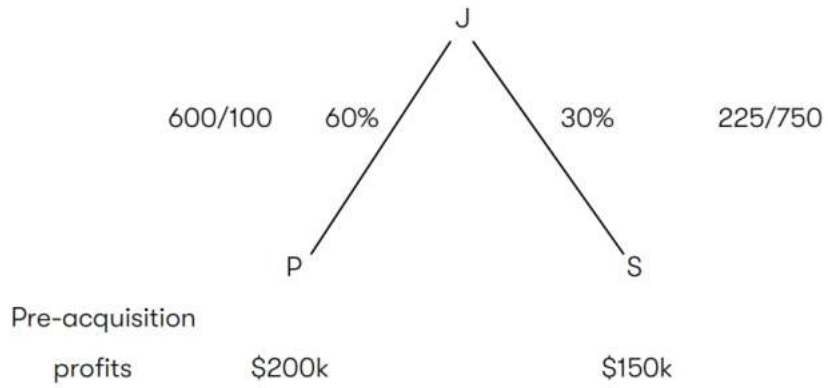
6 Associate

J GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

Assets	$'000
Non-current assets	
Freehold property (1,950 + 1,250 + 370 (W7))	3,570
Plant and equipment (795 + 375)	1,170
Investment in associate (W3)	480
	5,220
Current assets	
Inventories (575 + 300 – 20 (W6))	855
Trade receivables (330 + 290))	620
Cash at bank and in hand (50 + 120)	170
	1,645
	6,865
Equity and liabilities	
Equity attributable to owners of the parent	
Issued share capital	2,000
Retained earnings	1,785
	3,785
Non-controlling interests (W5)	890
Total equity	4,675
Non-current liabilities	
12% debentures (500 + 100)	600
Current liabilities	
Bank overdraft	560
Trade payables (680 + 350)	1,030
	1,590
Total liabilities	2,190
	6,865

Workings

1 *Group structure*



2 *Goodwill*

	$'000	$'000
Consideration transferred		1,000
NCI (at 'full' FV: 400 × $1.65)		660
Net assets acquired:		
Share capital	1,000	
Retained earnings at acquisition	200	
Fair value adjustment (W7)	400	
		(1,600)
		60
Impairments to date		(60)
Year-end value		–

3 *Investment in associate*

	$'000
Cost of associate	500.0
Share of post-acquisition retained reserves (W4)	72.0
Less impairment of investment in associate	(92.0)
	480.0

4 *Retained earnings*

	J Co $'000	*P Co* $'000	*S Co* $'000
Retained earnings per question	1,460	885	390
Unrealised profit (W6)		(20)	
Fair value adjustment movement (W6)		(30)	
Retained earnings at acquisition		(200)	(150)
		635	240
P Co: share of post-acquisition retained earnings 60% × 635	381		
S Co: share of post-acquisition retained earnings 30% × 240	72		
Goodwill impairments to date			
P Co: 60 (W2) × 60%	(36)		
S Co	(92)		
	1,785		

5 *Non-controlling interests*

	$'000
NCI at acquisition (W2)	660
NCI share of post-acquisition retained earnings ((W4) 635 × 40%)	254
NCI share of impairment losses ((W2) 60 × 40%)	(24)
	890

6 *Unrealised profit on inventories*

P Co ⟶ J Co $100k × 25/125 = $20,000

7 *Fair value adjustment table*

	At acquisition $'000	*Movement* $'000	*At reporting date* $'000
Land	200		200
Buildings	200	(30)	170 (200 × 34/40)
	400	(30)	370

7 Part disposal

(a) ANGEL GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X8

	$'000
Non-current assets	
Property, plant and equipment	200.00
Investment in Shane (W3)	133.15
	333.15
Current assets (890 + 120 (cash on sale))	1,010.00
	1,343.15
Equity attributable to owners of the parent	
Share capital	500.00
Retained reserves (W4)	533.15
	1,033.15
Current liabilities	310.00
	1,343.15

ANGEL GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X8

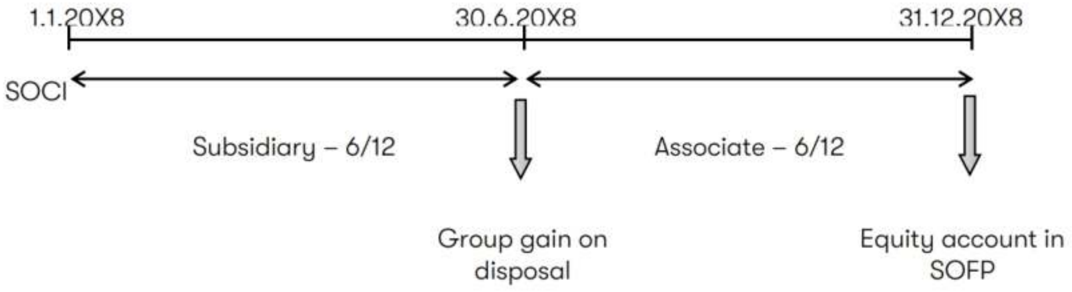
	$'000
Profit before interest and tax [100 + (20 × 6/12)]	110.00
Profit on disposal of shares in subsidiary (W6)	80.30
Share of profit of associate (12 × 35% × 6/12)	2.10
Profit before tax	192.40
Income tax expense [40 + (8 × 6/12)]	(44.00)
Profit for the year	148.40
Other comprehensive income (not reclassified to P/L) net of tax [10 + (6 × 6/12)]	13.00
Share of other comprehensive income of associate (6 × 35% × 6/12)	1.05
Other comprehensive income for the year	14.05
Total comprehensive income for the year	162.45
Profit attributable to:	
Owners of the parent	146.60
Non-controlling interests (12 × 6/12 × 30%)	1.80
	148.40
Total comprehensive income attributable to:	
Owners of the parents	159.75
Non-controlling interests (18 × 6/12 × 30%)	2.70
	162.45

ANGEL GROUP
CONSOLIDATED RECONCILIATION OF MOVEMENT IN RETAINED RESERVES

	$'000
Balance at 31 December 20X7 (W5)	373.40
Total comprehensive income for the year	159.75
Balance at 31 December 20X8 (W4)	533.15

Workings

1 *Timeline*



2 *Goodwill – Shane*

	$'000	$'000
Consideration transferred		120.0
Non-controlling interests (FV)		51.4
Less:		
Share capital	100	
Retained reserves	10	
		(110.0)
		61.4

3 *Investment in associate*

	$'000
Fair value at date control lost	130.00
Share of post 'acquisition' retained reserves (W4)	3.15
	133.15

4 *Group retained reserves*

	Angel $'000	*Shane* $'000 70%	*Shane* $'000 35% retained
Per question/date of disposal (90 – (18 × 6/12))	400.00	81	90
Group profit on disposal (W4)	80.30		
Less retained reserves at acquisition/date of disposal		(10)	(81)
		71	9
Shane: 70% × 71	49.70		
Shane: 35% × 9	3.15		
	533.15		

5 *Retained reserves b/f*

	Angel	Shane
	$'000	$'000
Per question	330.0	72
Less pre-acquisition retained reserves		(10)
	330.0	62
Shane – Share of post-acquisition ret'd reserves (62 × 70%)	43.4	
	373.4	

6 *Group profit on disposal of Shane*

	$'000	$'000
Fair value of consideration received		120.0
Fair value of 35% investment retained		130.0
Less share of carrying amount when control lost		
Net assets 190 – (18 × 6/12)	181.0	
Goodwill (W2)	61.4	
Less non-controlling interests (W7)	(72.7)	
		(169.7)
		80.3

7 *Non-controlling interests at date of disposal*

	$'000
Non-controlling interest at acquisition (FV)	51.4
NCI share of post-acq'n retained earnings (30% × 71(W4))	21.3
	72.7

(b) **Angel disposes of 10% of its holding**

If Angel disposes of 10% of its holding in Shane, Shane goes from being a 70% subsidiary to a 60% subsidiary. In other words **control is retained**. No accounting boundary has been crossed, and the event is treated as a transaction between owners.

The accounting treatment is as follows:

Statement of profit or loss and other comprehensive income

(i) The subsidiary is **consolidated in full** for the whole period.

(ii) The **non-controlling interest in the statement of profit or loss and other comprehensive income** will be based on percentage before and after disposal, ie time apportion.

(iii) There is **no profit or loss on disposal.**

Statement of financial position

(i) The **change (increase) in non-controlling interests** is shown as an **adjustment to the parent's equity.**

(ii) **Goodwill** on acquisition **is unchanged** in the consolidated statement of financial position.

In the case of Angel and Shane you would time apportion the non-controlling interest in the statement of profit or loss and other comprehensive income, giving 30% for the first half the year and 40% for the second half. You would also calculate the adjustment to the parent's equity as follows:

	$'000
Fair value of consideration received	X
Increase in NCI in net assets and goodwill at disposal	(X)
Adjustment to parent's equity	X

8 Step acquisition

(a) Prior to the acquisition of 20% on 1 March 20X1, **SD already controls KL** with its 60% investment, so **KL is already a subsidiary** and would be fully consolidated. In substance, this is **not an acquisition**. Instead, it is treated in the group accounts as a **transaction between the group shareholders** ie the parent has purchased a 20% shareholding from the non-controlling interests (NCI). No goodwill is calculated on the additional investment.

The value of the NCI needs to be worked out at the date of the additional investment (1 March 20X1), and the **proportion purchased by the parent needs to be removed from NCI**. The difference between the consideration transferred and the amount of the reduction in the NCI is included as an **adjustment to equity**.

KL must be **consolidated** in the group **statement of profit or loss and other comprehensive income** for the **full year** but **NCI will be pro-rated** with 40% for the first eight months and 20% for the following four months. In the **consolidated statement of financial position**, KL will be **consolidated with a 20% NCI**.

(b) (i) Goodwill $1,450,000 (W2)
(ii) Group retained earnings $9,843,999 (W3)
(iii) Non-controlling interests $1,096,001 (W4)

Workings

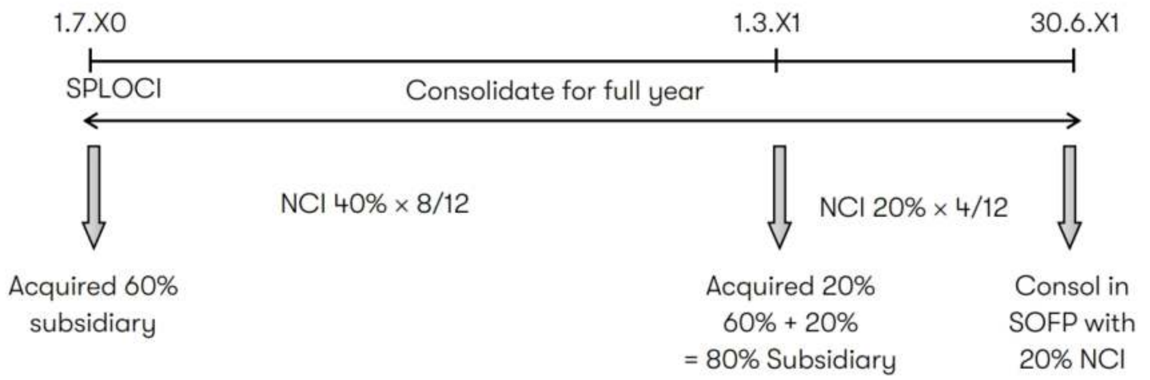
1 *Group structure*

SD

1.7.X0	60%
1.3.X1	20%
	80%

KL Pre-acquisition retained earnings $2,760,000

Timeline



2 *Goodwill (calculated at date when control was originally obtained)*

	$	$
Consideration transferred		3,250,000
NCI at fair value		1,960,000
Less net assets at acquisition:		
Share capital	1,000,000	
Pre-acquisition retained earnings (W1)	2,760,000	
		(3,760,000)
Goodwill		1,450,000

3 *Consolidated retained earnings*

	SD	KL 60%	KL 80%
	$	$	$
At year end/step acquisition	9,400,000	3,186,667	3,400,000
Unrealised profit (W5)			(60,000)
At acquisition/step acquisition		(2,760,000)	(3,186,667)
		426,667	153,333
Group share (60% × 426,667)	256,000		
(80% × 153,333)	122,666		
Adjustment to parent's equity W6)	65,333		
	9,843,999		

KL's retained earnings for the year to 30 June 20X1 (3,400,000 – 2,760,000) = $640,000

KL's retained earnings for the 8 months to 28 February 20X1 (640,000 × 8/12) = $426,667

KL's retained earnings as at 28 February 20X1 (2,760,000 + 426,667) = $3,186,667

4 *Non-controlling interest*

	$
NCI at acquisition	1,960,000
NCI share of post-acquisition retained earnings to 28.2.X1 (40% × 426,667 (W3))	170,667
	2,130,667
Decrease in NCI on further acquisition (20%/40% × 2,130,667)	(1,065,333)
NCI share of post-acquisition retained earnings to 30.6.X1 (20% × 153,333 (W3))	30,667
	1,096,001

5 *Provision for unrealised profit*

Intragroup sales by KL $750,000

Mark-up ($750,000 × $\frac{25}{125}$) × 40% = $60,000

(adjust in KL's retained earnings for the period **after** 1 March 20X1)

6 *Adjustment to equity on acquisition of further 20% of KL*

	$
Fair value of consideration paid	(1,000,000)
Decrease in NCI (W4)	1,065,333
Adjustment to equity	65,333

Adjustment would be:

	$	$
Debit (↓) Non-controlling interest	1,065,333	
Credit (↑) Group equity		65,333
Credit (↓) Cash (consideration)		1,000,000

9 Foreign operation

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$'000
Property, plant and equipment (1,285 + 543 (W2))	1,828
Goodwill (W4)	240
	2,068
Current assets (410 + 247 (W2))	657
	2,725
Share capital	500
Retained earnings (W5)	1,260
Other components of equity – translation reserve (W8)	98
	1,858
Non-controlling interest (W6)	131
	1,989
Loans (200 + 37 (W2))	237
Current liabilities (400 + 99 (W2))	499
	736
	2,725

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	$'000
Revenue (1,125 + 619 (W3))	1,744
Cost of sales (410 + 274 (W3))	(684)
Gross profit	1,060
Other expenses (180 + 108 (W3))	(288)
Goodwill impairment loss (W4)	(18)
Profit before tax	754
Income tax expense (180 + 76 (W3))	(256)
Profit for the year	498
Other comprehensive income	
Items that may subsequently be reclassified to profit or loss	
Exchange difference on translating foreign operations (W9)	69
Total comprehensive income for the year	567
Profit attributable to:	
Owners of the parent (balancing figure)	466
Non-controlling interests (W7)	32
	498
Total comprehensive income attributable to:	
Owners of the parent	525
Non-controlling interests (W7)	42
	567

Workings

1 *Group structure*

Standard

1.1.20X5 80%

Odense Pre-acquisition retained earnings = 2,500,000 krone

2 *Translation of Odense – Statement of financial position*

	Kr'000	Rate	$'000	
Property, plant and equipment	4,400	8.1	543	
Current assets	2,000	8.1	247	
	6,400		790	
Share capital	1,000	9.4	106	
Pre-acquisition retained earnings	2,500	9.4	266	
Post-acquisition retained earnings:				
• 20X5 profit	1,200	9.1	132	
• 20X5 dividend	(345)	8.8	(39)	470
• 20X6 profit	1,350	8.4	161	
• 20X6 dividend	(405)	8.1	(50)	
Exchange difference on net assets		Bal fig	78	
	5,300		654	
Loans	300	8.1	37	
Current liabilities	800	8.1	99	
	1,100		136	
	6,400		790	

3 *Translation of Odense – statement of profit or loss and other comprehensive income*

	Odense Kr'000	*Rate*	*Odense* $'000
Revenue	5,200	8.4	619
Cost of sales	(2,300)	8.4	(274)
Gross profit	2,900		345
Other expenses	(910)	8.4	(108)
Profit before tax	1,990		237
Income tax expense	(640)	8.4	(76)
Profit/Total comprehensive income for the year	1,350		161

4 *Goodwill*

	Kr'000	Kr'000	Rate	$'000
Consideration transferred (520 × 9.4)		4,888		520
Non-controlling interests (3,500 × 20%)		700		74
Share capital	1,000		9.4	
Retained earnings	2,500			
		(3,500)		(372)
		2,088		222
Exchange differences 20X5		–	β	15
At 31.12.X5		2,088	8.8	237
Impairment losses 20X6		(148)	8.1	(18)
Exchange differences 20X6		–	β	21
At 31.12.X6		1,940	8.1	240

5 *Consolidated retained earnings*

	Standard $'000	*Odense* $'000
At year end	1,115	470
At acquisition		(266)
		204
Group share of post-acquisition retained earnings (204 × 80%)	163	
Less: impairment losses to date (W4)	(18)	
	1,260	

6 *Non-controlling interests (statement of financial position)*

	$'000
NCI at acquisition (W4)	74
NCI share of post-acquisition retained earnings of Odense (204 (W5) × 20%)	41
NCI share of exchange differences on net assets (78 (W2) × 20%)	16
	131

7 *Non-controlling interests (statement of profit or loss and other comprehensive income)*

	PFY $'000	*TCI* $'000
Profit/Total comprehensive income for the year (W3)	161	161
Other comprehensive income: exchange differences on net assets (W9)	–	48
	161	209
NCI share	× 20%	× 20%
	= 32	= 42

8 *Consolidated translation reserve*

	$'000
Exchange differences on net assets (78 (W2) × 80%)	62
Exchange differences on goodwill (15 + 21 (W4))	36
	98

9 *Exchange differences*

	$'000
On translation of net assets:	
Closing NA @ CR (W2)	654
Opening NA @ OR (1,000 + 3,355 = 4,355* @ 8.8)	(495)
Less retained profit as translated (PFY – dividends)(161 (W3) – 405 @ 8.1)	(111)
	48
On goodwill (W4)	21
	69

* The opening net assets have been calculated as share capital (from Odense's statement of financial position) plus opening retained earnings (from Odense's statement of changes in equity extract). Alternatively, they could have been calculated as closing net assets less total comprehensive income for the year plus dividends: Kr(5,300,000 – 1,350,000 + 405,000).

Tutorial note.

As Standard chose to measure the non-controlling interest in Odense at the proportionate share of net assets at acquisition, only group goodwill is recognised in the consolidated statement of financial position and therefore, no goodwill is recognised for the non-controlling interests (NCI). Therefore, there are no exchange differences on goodwill relating to NCI. This is why only the exchange differences on net assets (and not the exchange differences on goodwill) are included in the NCI workings ((W6) and (W7)). Since all the recognised goodwill relates to the group, in the consolidated translation reserve working (W8), the exchange differences on goodwill are not multiplied by the group share.

If Standard had measured NCI at fair value at acquisition, both group goodwill and goodwill relating to the NCI would have been recognised. Therefore, in the NCI workings, the exchange differences on goodwill would be included. In the consolidated translation reserve working, the exchange differences on goodwill would be multiplied by the group share (in the same way as the exchange differences on net assets have been treated).

It might help if you think about the treatment of exchange differences on goodwill as being the same as the treatment for impairment losses on goodwill. So when NCI is measured at the proportionate share of net assets at acquisition, as all of the recognised goodwill relates to the group, all of the impairment losses and exchange differences on goodwill belong to the group so they should be recognised in full in the consolidated retained earnings and translation reserve workings respectively and neither would be included in NCI workings. Whereas for the full goodwill method, impairment losses and exchange differences on goodwill are apportioned between the group (in the retained earnings and translation reserve workings) and the NCI (in the NCI workings).

10 Consolidated statement of cash flows

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X5

	$'000	$'000
Cash flows from operating activities		
Profit before tax	16,500	
Adjustments for:		
Depreciation	5,800	
Impairment losses (W1)	240	
	22,540	
Increase in trade receivables (W4)	(1,700)	
Increase in inventories (W4)	(4,400)	
Increase in trade payables (W4)	1,200	
Cash generated from operations	17,640	
Income taxes paid (W3)	(4,200)	
Net cash from operating activities		13,440
Cash flows from investing activities		
Acquisition of subsidiary net of cash acquired	(600)	
Purchase of property, plant and equipment (W1)	(13,100)	
Net cash used in investing activities		(13,700)
Cash flows from financing activities		
Proceeds from issue of share capital (W2)	2,100	
Dividends paid (W2)	(900)	
Dividends paid to non-controlling interest (W2)	(40)	
Net cash from financing activities		1,160
Net increase in cash and cash equivalents		900
Cash and cash equivalents at the beginning of the period		1,500
Cash and cash equivalents at the end of the period		2,400

Workings

1 *Assets*

	Property, plant and equipment $'000	*Goodwill* $'000
b/d	25,000	–
OCI (revaluation)	500	
Depreciation/Impairment	(5,800)	**(240) β**
Acquisition of sub/associate	2,700	1,640 (W5)
Cash paid/(rec'd) β	**13,100**	–
c/d	35,500	1,400

2 *Equity*

	Share capital $'000	Share premium $'000	Retained earnings $'000	Non-controlling interest $'000
b/d	10,000	2,000	21,900	–
SPLOCI			11,100	350
Acquisition of subsidiary	1,500	2,500		1,440 (W5)
Cash (paid)/rec'd β	**800**	**1,300**	**(900)***	**(40)**
c/d	12,300	5,800	32,100	1,750

*Dividend paid is given in question but working shown for clarity.

3 *Liabilities*

	Tax payable $'000
b/d	4,000
P/L	5,200
Acquisition of subsidiary	200
Cash (paid)/rec'd	**(4,200) β**
c/d	5,200

4 *Working capital changes*

	Inventories $'000	Receivables $'000	Payables $'000
Balance b/d	10,000	7,500	6,100
Acquisition of subsidiary	1,600	600	300
	11,600	8,100	6,400
Increase/(decrease) (balancing figure)	**4,400**	**1,700**	**1,200**
Balance c/d	16,000	9,800	7,600

5 *Purchase of subsidiary*

	$'000
Cash received on acquisition of subsidiary	400
Less cash consideration	(1,000)
Cash outflow	(600)

Note. Only the **cash** consideration is included in the figure reported in the statement of cash flows. The **shares** issued as part of the consideration are reflected in the share capital working (W2) above.

Goodwill on acquisition (before impairment):

	$'000
Consideration: 55 + 695 (W3) + 120 (W2) + 216	5,000
Non-controlling interest: 4,800 × 30%	1,440
Net assets acquired	(4,800)
Goodwill	1,640

Section 2 – Exam-standard questions

11 Robby

Workbook references. The underlying principles of IFRS 3 are covered in Chapter 11. Business combinations achieved in stages are covered in Chapter 12. Joint operations are covered in Chapter 15 and financial instruments in Chapter 8. The *Conceptual Framework* is covered in Chapter 1.

Top tips. You must make sure that you explain the principles underlying the accounting for goodwill as the marks available for calculations are limited. The examining team is looking for an understanding of the accounting involved and not rote learning of consolidation workings.

In Part (b), you need to evaluate whether the requirements of IFRS 9 relating to the factoring arrangement are in agreement with the *Conceptual Framework*. This kind of evaluation in light of the *Conceptual Framework* is likely to be a feature of questions in the SBR examination, so you need to make sure you are familiar enough with the *Conceptual Framework* to be able to answer questions in this way.

Marking scheme

				Marks
(a)	(i)	Goodwill		
		Explanation of IFRS 3 principles	10	
		Hail – calculation	3	
		Zinc – calculation	3	
				16
	(ii)	Joint operation		
		SOFP	3	
		Explanation – 1 mark per point up to a maximum	4	
				7
(b)	Discussion – 1 mark per point up to a maximum			7
				30

(a) **Sections for inclusion in the finance director's report**

(i) **Goodwill**

IFRS 3 *Business Combinations* requires goodwill to be recognised in a business combination. A business combination takes place when one entity, the acquirer, obtains control of another entity, the acquiree. IFRS 3 requires goodwill to be calculated and recorded as a non-current asset at the acquisition date.

Goodwill is calculated at the acquisition date as the fair value of the consideration transferred by the acquirer plus the amount of any non-controlling interest less the fair value of the net assets of the acquiree. When the business combination is achieved in stages, as is the case for Zinc, the consideration transferred by the acquirer will include any previously held interest in the new subsidiary which must be remeasured to its fair value at the date control is obtained.

Goodwill is not amortised, but instead is tested for impairment at each year end.

Applying these principles, the goodwill on the acquisition of Hail and Zinc for inclusion in the consolidated financial statements at 31 May 20X3 is calculated as follows.

Goodwill related to the acquisition of Hail

Goodwill at acquisition:	\$m	\$m
Consideration transferred for 80% interest		
Cash payable on 1 June 20X1	50	
Deferred cash consideration (\$24.2 million/$(1.10)^2$)	20	
Contingent consideration	40	
Fair value of non-controlling interest	30	
		140
Fair value of identifiable net assets acquired	130	
Contingent liability	(2)	
		(128)
		12

The immediate, deferred and contingent consideration transferred should be measured at their fair values at the acquisition date.

Deferred consideration

The fair value of the deferred consideration is the amount payable on 31 May 20X4 discounted to its present value at the acquisition date. The requirement to discount to present value is consistent with other standards. The present value should be unwound in the period to 31 May 20X3 which will increase the carrying amount of the obligation and result in a finance cost in profit or loss. The unwinding of the discount does not affect the goodwill calculation as it is based on the amount payable at the date of acquisition.

Contingent consideration

The fair value of the contingent consideration payable should take into account the various milestones set under the acquisition agreement. At the acquisition date the fair value of the contingent consideration is \$40 million.

As the contingent consideration will be paid in cash, the amount payable should be remeasured at 31 May 20X3 to its fair value of \$42 million. This remeasurement does not affect the goodwill calculation, but the increase in the fair value of the obligation of \$2 million should be taken to profit or loss. If the contingent consideration was to be settled in equity, no remeasurement would be required.

Contingent liability

The contingent liability disclosed in Hail's financial statements is recognised as a liability on acquisition in accordance with IFRS 3, provided that its fair value can be reliably measured and it is a present obligation. This is contrary to the normal rules in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* where contingent liabilities are not recognised but only disclosed.

Conclusion

There is no indication that the goodwill balance is impaired at 31 May 20X3. Thus goodwill of \$12 million on acquisition of Hail should be included in the group financial statements at 31 May 20X3.

Goodwill related to the acquisition of Zinc

Substance over form drives the accounting treatment for a subsidiary acquired in stages. The legal form is that shares have been acquired, however, in substance:

(1) The 5% investment has been 'sold'. Per IFRS 3, the investment previously held is remeasured to fair value at the date control is obtained and a gain or loss reported in profit or loss:

	$m
Fair value of 5% at date control achieved (1 December 20X2)	5
Fair value of carrying amount of 5% per SOFP at 31 May 20X2	(3)
Remeasurement gain (1 June 20X2 to 1 December 20X2)	2

(2) A subsidiary has been 'purchased'. The previously held 5% investment is effectively re-acquired at fair value, and so goodwill is calculated including the fair value of the previously held 5% investment.

Goodwill	$m	$m
Consideration transferred – for 55%	16	
Fair value of non-controlling interest	9	
Fair value of previously held interest (for 5% at 1 December 20X2)	5	
		30
Fair value of identifiable net assets at acquisition:		
Provisional measurement	26	
Adjustment to fair value of PPE (within measurement period)	3	
		(29)
		1

Fair value of PPE

The fair value of PPE was provisional at the date of acquisition, with an increase of $3 million subsequently identified when the figures were finalised in March 20X3. IFRS 3 permits adjustments to goodwill for adjustments to the fair value of assets and liabilities acquired, provided this adjustment is made within one year of the date of acquisition (the measurement period).

Conclusion

There is no indication that the goodwill balance is impaired at 31 May 20X3. Thus goodwill related to the acquisition of Zinc to be included in the group financial statements at 31 May 20X3 is $1 million.

(ii) **Joint operation**

Robby has a joint arrangement with another party in respect of the natural gas station. Under IFRS 11 *Joint Arrangements*, a joint arrangement is one in which two or more parties are bound by a contractual arrangement which gives them joint control over the arrangement.

Joint arrangements can either be joint ventures or joint operations. The classification as a joint venture or joint operation depends on the rights and obligations of the parties to the arrangement. It is important to correctly classify the arrangement as the accounting requirements for joint ventures are different to those for joint operations.

IFRS 11 states that a joint arrangement that is not structured through a separate vehicle is a joint operation. In Robby's case, no separate entity has been set up for the joint arrangement, therefore it is a joint operation. Robby has joint rights to the assets and revenue, and joint obligations for the liabilities and costs of the joint arrangement.

Therefore, Robby, in its capacity as a joint operator, must recognise on a line-by-line basis its own assets, liabilities, revenues and expenses plus its share (40%) of the joint assets, liabilities, revenue and expenses of the joint operation as prescribed by IFRS 11. This treatment is applicable to both the consolidated and separate financial statements of Robby.

The figures are calculated as follows:

Statement of financial position

	$m
Property, plant and equipment:	
1 June 20X2 cost: gas station (15 × 40%)	6.00
dismantling provision (2 × 40%)	0.80
	6.80
Accumulated depreciation: 6.8/10 years	(0.68)
31 May 20X3 carrying amount	6.12
Trade receivables (from other joint operator): 20 (revenue) × 40%	8.00
Trade payables (to other joint operator): (16 + 0.5) (costs) × 40%	6.60
Dismantling provision:	
At 1 June 20X2	0.80
Finance cost (unwinding of discount): 0.8 × 5%	0.04
At 31 May 20X3	0.84

(b) **Accounting treatment**

Trade receivables are financial assets and therefore the requirements of IFRS 9 *Financial Instruments* need to be applied. The main question here is whether the factoring arrangement means that Robby should derecognise the trade receivables from the financial statements.

Per IFRS 9, an entity should derecognise a **financial asset** when:

(1) The **contractual rights** to the cash flows from the financial asset **expire**; or

(2) The entity **transfers the financial asset or substantially all the risks and rewards of ownership** of the financial asset to another party.

In the case of Robby, the contractual rights to the cash flows have not expired as the receivables balances are still outstanding and expected to be collected.

In respect of the risks and rewards of ownership, the substance of the factoring arrangement needs to be considered rather than its legal form. Robby has transferred the receivables to the bank in exchange for $3.6 million cash, but remains liable for any shortfall between $3.6 million and the amount collected. In principle, Robby is liable for the whole $3.6 million, although it is unlikely that the default would be as much as this. **Robby therefore retains the credit risk.**

In addition, Robby is entitled to receive the benefit (less interest) of repayments in excess of $3.6 million once the $3.6 million has been collected and therefore retains the potential rewards of full settlement.

Substantially all the risks and rewards of the financial asset **therefore remain with Robby**, and the receivables should **continue to be recognised**. In addition, a **financial liability** should be recognised in respect of the consideration received from the bank.

Conceptual Framework

According to the *Conceptual Framework* derecognition normally occurs when **control** of all or part of an asset is lost.

The requirements for derecognition should aim to **faithfully represent** both:

(a) Any assets and liabilities retained after derecognition; and
(b) The change in the entity's assets and liabilities as a result of derecognition.

Meeting both of these aims becomes difficult if the entity disposes of only part of an asset or retains some exposure to that asset. It can be difficult to faithfully represent the legal form (which in this case is the decrease in assets under the factoring arrangement) with the substance of retaining the corresponding risks and rewards.

Because of the difficulties in practice in meeting these two aims, the *Conceptual Framework* does not advocate using a control approach or the risks-and-rewards approach to derecognition in every circumstance. Instead, it describes the options available and discusses what factors the IASB would need to consider when developing Standards.

As such, there appears to be no conflict in principles between the *Conceptual Framework* and the requirements of IFRS 9 for derecognition.

12 Banana Co

Marking scheme

				Marks
(a)	(i)	Application of the following discussion to the scenario:		
		Goodwill and contingent consideration	3	
		Why the existing goodwill valuation is incorrect	4	
		Correcting entry	1	
				8
	(ii)	Application of the following discussion to the scenario:		
		Nature of significant influence	2	
		The equity method of accounting for an associate	1	
		Calculation of the carrying amount of the investment	1	
				4
	(iii)	Calculation of the gain on disposal of Strawberry	2	
		Application of the following discussion to the scenario:		
		Rationale for the calculation of gain on disposal	1	
		Correct treatment of Strawberry after disposal	1	
				4
(b)		Application of the following discussion to the scenario:		
		IFRS 3 definition of a business	3	
		Rationale for inclusion as either an asset acquisition or as a business	4	
				7
(c)		Application of the following discussion to the scenario:		
		Consideration of IFRS 9 principles	4	
		Transfer of rights/conclusion	1	
		Carrying amount of bonds	2	
				7
				30

(a) **Explanatory note to: Directors of Banana Co**

Subject: Consolidation of Grape Co and Strawberry Co

(i) Goodwill should be calculated by comparing the fair value of the consideration with the fair value of the identifiable net assets at acquisition. The shares have been correctly valued using the market price of Banana Co at acquisition. Contingent consideration should be included at its fair value which should be assessed taking into account the probability of the targets being achieved as well as being discounted to present value. It would appear reasonable to measure the consideration at a value of $4 million ($16 million × 25%). A corresponding liability should be included within the consolidated financial statements with subsequent remeasurement. This would be adjusted prospectively to profit or loss rather than adjusting the consideration and goodwill.

The finance director has erroneously measured non-controlling interest using the proportional method rather than at fair value. Although either method is permitted on an acquisition by acquisition basis, the accounting policy of the Banana group is to measure non-controlling interest at fair value. The fair value of the non-controlling interest at acquisition is (20% × $20 million × $4.25) = $17 million.

Net assets at acquisition were incorrectly included at their carrying amount of $70 million. This should be adjusted to fair value of $75 million with a corresponding $5 million increase to land in the consolidated statement of financial position. Goodwill should have been calculated as follows:

	$m
Fair value of share exchange	68
Contingent consideration	4
Non-controlling interest at acquisition	17
Fair value of identifiable net assets acquired	(75)
Goodwill	14

The correcting entry required to the consolidated financial statements is:

Debit	Goodwill	$2 million	
Debit	Land	$5 million	
Credit	Non-controlling interest		$3 million
Credit	Liabilities		$4 million

(ii) If an entity holds 20% or more of the voting power of the investee, it is presumed that the entity has significant influence unless it can be clearly demonstrated that this is not the case. The existence of significant influence by an entity is usually evidenced by representation on the board of directors or participation in key policy making processes. Banana Co has 40% of the equity of Strawberry Co and can appoint one director to the board. It would appear that Banana Co has significant influence but not control. Strawberry Co should be classified as an associate and be equity accounted for within the consolidated financial statements.

The equity method is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income. At 1 October 20X7, Strawberry Co should have been included in the consolidated financial statements at a value of $20.4 million ($18 million + 40% × $50 million – $44 million).

(iii) On disposal of 75% of the shares, Banana Co no longer exercises significant influence over Strawberry Co and a profit on disposal of $3.1 million should have been calculated.

	$m
Proceeds	19.0
Fair value of retained interest	4.5
Carrying amount of investment in associate (see part (ii))	(20.4)
Gain on disposal	3.1

Banana Co is incorrect to have recorded a loss in reserves of $14 million and this should be reversed. Instead, a gain of $3.1 million should have been included within the consolidated statement of profit or loss. The investment is initially restated to fair value of $4.5 million. Banana Co does not intend to sell their remaining interest and providing that they make an irrecoverable election, they can treat the remaining interest at fair value through other comprehensive income. The investment will be restated to $4 million at the reporting date with a corresponding loss of $0.5 million reported in other comprehensive income.

(b) Melon Co should only be treated as an asset acquisition if the acquisition fails the definition of a business combination. In accordance with IFRS 3 *Business Combinations*, an entity should determine whether a transaction is a business combination by applying the definition of a business in IFRS 3.

A business combination arises when an acquirer obtains control of a business. According to IFRS 3, a business is an integrated set of activities and assets which are capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income or generating other income from ordinary activities. A business has inputs and processes which are applied to create outputs.

An input is any economic resource that can be used to create outputs, including tangible and intangible assets such as intellectual property.

A process is any system, standard, protocol, convention or rule that, with inputs, contributes to the creation of outputs.

Outputs are the result of inputs and processes. Outputs provide goods or services to customers, generate investment income such as dividends or interest, or generate other income from ordinary activities.

If an acquired set of activities and assets is generating revenue at the acquisition date, it is considered to have outputs.

It is clear that Melon Co has both inputs and processes. The licence is an input as it is an economic resource within the control of Melon Co which is capable of providing outputs once one or more processes are applied to it. Processes are in place through the research activities, integration with the management company and supervisory and administrative functions performed. The research activities are still at an early stage, so no output is yet obtainable.

To meet the IFRS 3 definition of a business, the acquired set of activities and assets must have inputs (which Melon Co does) and *substantive* processes that can significantly contribute to the creation of outputs.

To be considered substantive, the acquired process must be essential to convert an acquired input into outputs, and the inputs acquired must include an organised workforce capable of performing the process on other acquired inputs to produce outputs.

Therefore, due to the absence of a substantive process, Melon Co fails the IFRS 3 definition of a business and the directors are correct to treat the purchase of Melon Co as an asset acquisition.

(c) IFRS 9 *Financial Instruments* requires that a financial asset only qualifies for derecognition once the entity has transferred the contractual rights to receive the cash flows from the asset or where the entity has retained the contractual rights but has an unavoidable obligation to pass on the cash flows to a third party. The substance of the disposal of the bonds needs to be assessed by a consideration of the risks and rewards of ownership.

Banana Co has not transferred the contractual rights to receive the cash flows from the bonds. The third party is obliged to return the coupon interest to Banana Co and to pay additional amounts should the fair values of the bonds increase. Consequently, Banana Co still has the rights associated with the interest and will also benefit from any appreciation in the value of the bonds. Banana still retains the risks of ownership as it has to compensate the third party should the fair value of the bonds depreciate in value.

It would be expected that, if the sale were a genuine transfer of risks and rewards of ownership, then the sales price would be approximate to the fair value of the bonds. It would only be in unusual circumstances such as a forced sale of Banana Co's assets arising from severe financial difficulties that this would not be the case. The sales price of $8 million is well below the current fair value of the bonds of $10.5 million. Additionally, Banana Co is likely to exercise their option to repurchase the bonds.

It can be concluded that no transfer of rights has taken place and therefore the asset should not be derecognised. To measure the asset at amortised cost, the entity must have a business model where they intend to collect the contractual cash flows over the life of the asset. Banana Co maintains these rights and therefore the sale does not contradict their business model. The bonds should continue to be measured at amortised cost in the consolidated financial statements of Banana Co. The value of the bonds at 30 June 20X6 would have been $10.2 million ($10 million + 7% × $10 million – 5% × $10 million). Amortised cost prohibits a restatement to fair value. The value of the bonds at 30 June 20X7 should be $10.414 million ($10.2 million + 7% × $10.2 million – 5% × $10 million). The proceeds of $8 million should be treated as a financial liability and would also be measured at amortised cost. An interest charge of $0.8 million would accrue between 1 July 20X6 and 1 July 20X8, being the difference between the sale and repurchase price of the bonds.

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Marking scheme

			Marks
(a)	Application of the following discussion to the scenario:		
	• Deferred consideration	2	
	• Property, plant and equipment	2	
	• NCI	1	
	• Goodwill impairment	3	
	Goodwill calculations and corrections required	5	
			13
(b)	Calculations of:		
	• Profit on disposal	3	
	• Treatment as associate	1	
			4
(c)	Application of the following discussion to the scenario:		
	• Compound instrument treatment	3	
	• Calculation of liability and adjustments	2	
			5
(d)	Application of the following discussion to the scenario:		
	• Treatment of deferred tax asset	4	
	• Implications of loan covenant breach	4	
			8
			30

(a) **Deferred consideration**

When calculating goodwill, IFRS 3 *Business Combinations* states that purchase consideration should be measured at fair value. For deferred cash consideration, this will be the present value of the cash flows. This amounts to \$29 million (\$32m × 1/(1.05^2) or \$32m × 0.907). Goodwill arising on acquisition should be increased by \$29 million and a corresponding liability should be recognised:

Debit Goodwill	\$29 million	
Credit Liability		\$29 million

Interest of \$1.5 million (\$29m × 5%) should be recorded. This is charged to the statement of profit or loss and increases the carrying amount of the liability:

Debit Finance costs	\$1.5 million	
Credit Liability		\$1.5 million

Property, plant and equipment (PPE)

During the measurement period IFRS 3 states that adjustments should be made retrospectively if new information is determined about the value of consideration transferred, the subsidiary's identifiable net assets, or the non-controlling interest. The measurement period ends no later than 12 months after the acquisition date.

The survey detailed that Chandler's PPE was overvalued by \$10 million as at the acquisition date. It was received four months after the acquisition date and so this revised valuation was received during the measurement period. As such, goodwill at acquisition should be recalculated. As at the acquisition date, the carrying amount of PPE should be reduced by \$10 million and the carrying amount of goodwill increased by \$10 million:

Debit Goodwill	\$10 million	
Credit PPE		\$10 million

NCI

The NCI at acquisition was valued at \$34 million but it should have been valued at \$32 million ((\$170m – \$10m PPE adjustment) × 20%). Both NCI at acquisition and goodwill at acquisition should be reduced by \$2 million:

Debit NCI	\$2 million	
Credit Goodwill		\$2 million

Goodwill

Goodwill arising on the acquisition of Chandler should have been calculated as follows:

	\$m
Fair value of consideration (\$150m + \$29m)	179
NCI at acquisition	32
Fair value of identifiable net assets acquired	(160)
Goodwill at acquisition	51

Goodwill impairment

According to IAS 36 *Impairment of Assets*, a cash-generating unit to which goodwill is allocated should be tested for impairment annually by comparing its carrying amount to its recoverable amount. As goodwill has been calculated using the proportionate method, then this must be grossed up to include the goodwill attributable to the NCI.

	\$m	\$m
Goodwill	51.0	
Notional NCI (\$51m × 20/80)	12.8	
Total notional goodwill		63.8

	$m	$m
Net assets at reporting date:		
Fair value at start of period	160.0	
Profit for period	52.0	
		212.0
Total carrying amount of assets		275.8
Recoverable amount		(250.0)
Impairment		25.8

The impairment is allocated against the total notional goodwill. The NCI share of the goodwill has not been recognised in the consolidated financial statements and so the NCI share of the impairment is also not recognised. The impairment charged to profit or loss is therefore $20.6 million ($25.8m × 80%) and this expense is all attributable to the equity holders of the parent company.

Debit	Operating expenses	$20.6 million	
Credit	Goodwill		$20.6 million

The carrying amount of the goodwill relating to Chandler at the reporting date will be $30.4 million ($51m acquisition – $20.6m impairment).

(b) **Doyle Co**

Until 1 April 20X6, Doyle Co is a subsidiary of Hill Co and so should be consolidated until that date. The sale of the shares on 1 April 20X6, results in Hill Co losing control over Doyle Co. The goodwill, net assets and NCI of Doyle Co must be derecognised from the consolidated statement of financial position. The difference between the proceeds from the disposal (including the fair value of the shares retained) and these amounts will give rise to a $47 million profit on disposal. This is calculated as follows:

	$m	$m
Proceeds	140	
Fair value of remaining interest	300	
		440
Goodwill at disposal		(50)
Net assets at disposal		(590)
NCI:		
At acquisition	215	
NCI % of post acquisition profit (40% × ($590m – $510m))	32	
NCI at disposal		247
Profit on disposal		47

After the share sale, Hill Co owns 40% of Doyle Co's shares and has the ability to appoint two of the six members of Doyle Co's board of directors. IAS 28 *Investments in Associates and Joint Ventures* states that an associate is an entity over which an investor has significant influence. Significant influence is presumed when the investor has a shareholding of between 20 and 50%. Representation on the board of directors provides further evidence that significant influence exists.

Therefore, the remaining 40% shareholding in Doyle Co should be accounted for as an associate. It will be initially recognised at its fair value of $300 million and accounted for using the equity method. This means that the group recognises its share of the associate's profit after tax, which equates to $24.6 million ($123m × 6/12 × 40%). As at the reporting date, the associate will be carried at $324.6 million ($300m + $24.6m) in the consolidated statement of financial position.

(c) **Convertible bond**

Hill Co has issued a compound instrument because the bond has characteristics of both a financial liability (an obligation to repay cash) and equity (an obligation to issue a fixed number of Hill's own shares). IAS 32 *Financial Instruments: Presentation* specifies that compound instruments must be split into:

- A liability component (the obligation to repay cash); and
- An equity component (the obligation to issue a fixed number of shares).

The split of the liability component and the equity component at the issue date is calculated as follows:

- The liability component is the present value of the cash repayments, discounted using the market rate on non-convertible bonds;
- The equity component is the difference between the cash received and the liability component at the issue date.

The initial carrying amount of the liability should have been measured at $17.9 million, calculated as follows:

Date	*Cash flow*	*Discount rate*	*Present value*
	$m		$m
30 September 20X6	0.8	0.909	0.73
30 September 20X7	20.8	0.826	17.18
			17.91

The equity component should have been initially measured at $2.1 million ($20m – $17.9m). The adjustment required is:

Debit Non-current liabilities	$2.1m	
Credit Equity		$2.1m

The equity component remains unchanged. After initial recognition, the liability is measured at amortised cost, as follows:

1 October 20X5	*Finance charge (10%)*	*Cash paid*	*30 September 20X6*
$m	$m	$m	$m
17.9	1.8	(0.8)	18.9

The finance cost recorded for the year was $0.8 million and so must be increased by $1.0 million ($1.8m – $0.8m).

Debit Finance costs	$1.0m	
Credit Non-current liabilities		$1.0m

The liability has a carrying amount of $18.9 million as at the reporting date.

(d) **Deferred tax**

According to IAS 12 *Income Taxes*, an entity should recognise a deferred tax asset in respect of the carry-forward of unused tax losses to the extent that it is probable that future taxable profit will be available against which the losses can be utilised. IAS 12 stresses that the existence of unused losses is strong evidence that future taxable profit may not be available. For this reason, convincing evidence is required about the existence of future taxable profits.

IAS 12 says that entities should consider whether the tax losses result from identifiable causes which are unlikely to recur. Hill has now made losses in three consecutive financial years, and therefore significant doubt exists about the likelihood of future profits being generated.

Although Hill Co is forecasting an improvement in its trading performance, this is a result of new products which are currently under development. It will be difficult to reliably forecast the performance of these products. More emphasis should be placed on the performance of existing products and existing customers when assessing the likelihood of future trading profits.

Finally, Hill Co breached a bank loan covenant and some uncertainty exists about its ability to continue as a going concern. This, again, places doubts on the likelihood of future profits and suggests that recognition of a deferred tax asset for unused tax losses would be inappropriate.

Based on the above, it would seem that Hill Co is incorrect to recognise a deferred tax asset in respect of its unused tax losses.

Covenant breach

Hill Co is currently presenting the loan as a non-current liability. IAS 1 *Presentation of Financial Statements* states that a liability should be presented as current if the entity:

- Settles it as part of its operating cycle;
- Holds the liability primarily for the purpose of trading;
- Is due to settle the liability within 12 months of the reporting date; or
- Does not have the right at the end of the reporting period to defer settlement for at least 12 months after the reporting date.

Hill Co breached the loan covenants before the reporting date but only received confirmation after the reporting date that the loan was not immediately repayable. As per IAS 10 *Events after the Reporting Period*, the bank confirmation is a non-adjusting event because, as at the reporting date, Hill did not have the right to defer settlement of the loan for at least 12 months. IAS 1 is clear that this right only exists if the entity complies with any required conditions at the reporting date, even if compliance is not tested until later. In the statement of financial position as at 30 September 20X6 the loan should be reclassified as a current liability.

Going concern

Although positive forecasts of future performance exist, management must consider whether the breach of the loan covenant and the recent trading losses place doubt on Hill Co's ability to continue as a going concern. If material uncertainties exist, then disclosures should be made in accordance with IAS 1.

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Workbook references. Fair value measurement under IFRS 13 and IAS 36 *Impairment of Assets* are both covered in Chapter 4. The underlying principles of acquisition accounting given in IFRS 3 *Business Combinations* are covered in Chapter 11. Share-based payment is covered in Chapter 10.

Top tips. Question 1 of the real exam will always test group accounting as well as other financial reporting issues. In this question, part (a)(i) required an explanation of how the fair value of a factory site is determined as part of the acquisition of a subsidiary. This required knowledge of IFRS 13. Part (a)(ii) required the calculation of goodwill on acquisition measuring the non-controlling interest (NCI) under both fair value and proportionate share of net assets. The examiner commented that no explanation was needed to support these goodwill calculations, but that some candidates provided an explanation anyway. This explanation would have not gained any marks as it was not required by the question – make sure you read the questions requirements carefully and only provide explanations for calculations if specified.

Part (b) required a discussion and calculation of an impairment loss relating to a subsidiary, including an explanation of how the impairment would differ depending upon the measurement of non-controlling interest. The examiner commented that very few candidates explained the need for grossing-up goodwill when NCI is measured at the proportionate share of net assets. Make sure you review the suggested solution below carefully if you are unsure of the need to gross up goodwill in this way.

Part (c)(i) regarding the share-based payment was tricky - but you should have been able to pick up some marks in this part of the question for discussing the share exchange. With questions like this, if you are unsure, you should have a go at this part of the question, but make sure you don't spend more than the allocated time of 1.95 minutes per mark.

Part (c)(ii) asked for the resulting share-based expense and a discussion of the vesting conditions. The examiner commented that this was not well answered. If you are unsure about share-based payments, go back to your Workbook, Chapter 10, to revise.

Marking scheme

				Marks
(a)	(i)	Application of the following discussion to the scenario:		
		How FV should be determined	5	
		Why depreciation replacement cost is unsuitable	2	
				7
	(ii)	Calculation marks for:		
		Correct FV of net assets	1	
		Correct NCI figures	2	
				3
(b)	Discussion of what constitutes an impairment and CGUs		2	
	Correct calculation of impairment losses for both methods		2	
	Notional goodwill		1	
	Impairment allocation		3	
	Discussion of how and why methods differ		3	
				11
(c)	(i)	Calculation FV of deferred shares	1	
		Calculation of FV of options	1	
		Discussion of the above calculations and Application to the scenario	2	
				4
	(ii)	Calculation share expense	1	
		Application of the following discussion to the scenario:		
		Why expense required	2	
		Vesting conditions	2	
				5
				30

(a) (i) IFRS 13 *Fair Value Measurement* permits a range of valuation methods to estimate fair value including market based, income estimates and a cost-based approach. However, the characteristics of each asset should be considered when determining the most appropriate methodology.

Fair value is defined as the price which would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is therefore not supposed to be entity specific but rather to be market focused. The estimate consequently should consider what the market would be prepared to pay for the asset.

The market would consider all alternative uses for the assessment of the price which they would be willing to pay. Fair value should therefore be measured by consideration of the highest and best use of the asset. There is a presumption that the current use would be the highest and best use.

The highest and best use of the asset would appear to be as residential property and not the current industrial use. The intentions of Colyson Co are not relevant as fair value is not entity specific. The alternative use would need to be based upon fair and reasonable assumptions. In particular, it would be necessary to ensure that planning permission to demolish the factory and convert into residential properties would be likely. Since several nearby sites have been given such permission, this would appear to be the case.

The fair value of the factory site should be valued as if converted into residential use. Since this cannot be determined on a stand-alone basis, the combined value of the land and buildings is calculated. The $1 million demolition and planning costs should be deducted from the market value of $24 million. The fair value of the land and buildings should be $23 million. The fair value of the identifiable net assets at acquisition are $88 million ($65m + $23m).

Depreciated replacement cost should only be considered as a possible method for estimating the fair value of the asset when other more suitable methods are not available. This may be the case when the asset is highly specialised and market data is therefore limited or unavailable. This is not the case with the factory site. In any case, the rise in value of land and properties particularly for residential use would mean that to use depreciated replacement cost would undervalue the asset. The exit value for the asset, whether it was based on the principal or most advantageous market, would need to be the same as the entry price. Depreciation may not also be an accurate reflection of all forms of obsolescence including physical deterioration. The estimate would need to be adjusted for such factors even where industrial use remained the best use of the asset.

(ii) Goodwill should be calculated as follows:

	Fair value method	*Proportional method*
	$m	$m
Consideration	90	90
Non-controlling interest (NCI) at acquisition	22	17.6
Net assets at acquisition	(88)	(88)
Goodwill	24	19.6

NCI at acquisition under proportional method is $17.6 million (20% × $88m).

The fair value of the net assets at acquisition is $88 million as per part a(i) ($65m + $23m).

Tutorial note: Goodwill under the proportional method could also be calculated as:

Consideration	$90m
Less FV of net assets acquired (80% × $88m)	($70.4)m
Goodwill on acquisition	$19.6m

(b) An impairment arises where the carrying amount of the net assets exceeds the recoverable amount. Where there is a clear indication of impairment, this asset should be reduced to the recoverable amount.

Where the cash flows cannot be independently determined for individual assets, they should be assessed as a cash generating unit. That is the smallest group of assets which independently generate cash flows. Impairments of cash generating units are allocated first to goodwill and then pro rata on the other assets. It should be noted that no asset should be reduced below its recoverable amount.

Fair value method

The overall impairment of Colyson Co is $30 million ($106m + goodwill $24m – $100m). The damaged building should be impaired by $4 million with a corresponding charge to profit or loss. Since $4 million has already been allocated to the land and buildings, $26 million remains. The goodwill should therefore be written off and expensed in the consolidated statement of profit or loss.

Of the remaining $2 million, $1.25 million will be allocated to the plant and machinery (15/(15 + 9) × 2m) and $0.75 million will be allocated to the remaining intangibles (9/(9 + 15) × 2m). As no assets have been previously revalued, all the impairments are charged to profit or loss. $24 million (80% × $30m) will be attributable to the owners of Luploid Co and $6 million to the NCI in the consolidated statement of comprehensive income.