The allocation of the impairment is summarised in this table:

	Original value	*Impairment*	*Revised CV*
	$m	$m	$m
Land and buildings	60	4	56
Plant and machinery	15	1.25	13.75
Intangibles other than goodwill	9	0.75	8.25
Goodwill	24	24	0
Current assets (at recoverable amount)	22	0	22
Total	130	30	100

Proportionate method

The basic principles and rule for impairment is the same as the fair value method and so $4 million will again first be written off against the land and buildings. The problems arise when performing the impairment review as a cash generating unit. When NCI is measured using the proportional share of net assets, no goodwill is attributable to the NCI since goodwill is not included within the individual net assets of the subsidiary. This means that the goodwill needs to be grossed up when an impairment review is performed so that it is comparable with the recoverable amount. Under the fair value method, the NCI fully represents any premium the other shareholders would be prepared to pay for the net assets and so goodwill does not need to be grossed up.

The goodwill of $19.6 million is grossed up by 100/80 to a value of $24.5 million. This extra $4.9 million is known as notional goodwill. The overall impairment is now $30.5 million ($106m + $24.5m – $100m) of which $4 million has already been allocated. Since the remaining impairment of $26.5 million exceeds the value of goodwill, the goodwill is written down to zero. However, as only $19.6 million goodwill is recognised within the consolidated accounts, the impairment attributable to the notional goodwill is not recognised. Only $19.6 million is deducted in full from the owners of Luploid Co's share of profits since there is no goodwill attributable to the non-controlling interest. The remaining $2 million impairment is allocated between plant and machinery and intangibles (other than goodwill). NCI will be allocated 20% of $6 million ($4m + $2m), ie $1.2 million. Consolidated retained earnings will be charged with 80% of $6 million (ie $4.8 million) plus $19.6 million goodwill impairment (ie $24.4m in total). The allocation of the impairment is summarised in this table:

Tutorial note: Notional goodwill and impairment of notional goodwill does not impact on the consolidated financial statements.

	Original carrying amount	*Impairment*	*Revised carrying amount*
	$m	$m	$m
Land and buildings	60	4	56
Plant and machinery	15	1.25	13.75
Intangibles other than goodwill	9	0.75	8.25
Goodwill	19.6	19.6	0
(Notional goodwill)	4.9	4.9	0
Current assets (at recoverable amount)	22		22
Total	130.5	30.5	100

(c) (i) IFRS 3 *Business Combinations* requires all consideration to be measured at fair value on acquisition of a subsidiary. This will include the deferred shares. Since Luploid Co is obliged to replace the share-based scheme of Hammond Co on acquisition, the replacement scheme should also be included as consideration. There is, however, a post combination service period which means that the portion of the replacement scheme attributable to pre-combination service is the market value of the acquiree award multiplied by the ratio of the portion of the vesting period completed to the greater of the total vesting period or the original vesting period of the acquire award.

The vesting period of the acquiree award had vested and was three years. As there is a two-year post combination vesting period, the total vesting period is five years. Therefore the amount attributable to the pre-combination period (and therefore added to the cost of the investment) should be \$15 million × 3/5 = \$9 million.

Deferred shares should be measured at the fair value at the acquisition date with subsequent changes in fair value ignored. Luploid Co will issue 2.4 million

(60% × 10m × 2/5) shares as consideration. The market price at the date of acquisition was \$30, so the fair value is \$72 million. The total consideration should be valued as \$81 million (72 + 9).

(ii) The fair value of the replacement scheme at the grant date is \$18 million (100 × 10,000 × 90% × \$20). Since \$9 million has been allocated to the cost of the investment, the remaining \$9 million should be treated as part of the post combination remuneration package for the employees and measured in accordance with IFRS 2 *Share-based Payment*. The fair value at the grant date of the share-based scheme should be expensed to profit or loss over the two-year vesting period. Subsequent changes to the fair value of the shares are ignored.

Lupoid Co will need to consider the impact of market and non-market based vesting conditions. The condition relating to the share price of Luploid Co is a market based vesting condition. These are adjusted for in the calculation of the fair value at the grant date of the option. An expense is therefore recorded in the consolidated profit or loss of Luploid Co irrespective of whether the market based vesting condition is met or not. A corresponding credit should be included within equity.

15 Sugar Co

Marking scheme

			Marks
(a)	Application of the following discussion to the scenario:		
	• Treatment as an associate (including FV 40% and share exchange at 1 July 20X7)	5	
	• FV NCI and identifiable net assets at 1 July 20X7	3	
	Goodwill calculation and treatment of cash consideration	2	
			10

			Marks
(b)	Marks for calculations as follows:		
	Acquisition of intangible assets	3	
	Proceeds on disposal of PPE	3	
	Cash paid for Butter Co	1	
	Dividends received from associates	2	
	Investment income received	3	
	Issue of ordinary shares	2	
	Non-controlling interest dividend	2	
			16
(c)	Application of the following discussion to the scenario:		
	• Cash flows to include/exclude	2	
	• Other elements of defined benefit scheme	2	
			4
			30

(a) **Cash paid to acquire Flour Co**

The acquisition of Flour Co is a step acquisition. This means the original 40% equity interest is treated as if it is disposed and then reacquired at fair value. The difference between the carrying amount of the original 40% equity interest and its fair value would be included as a gain within profit or loss. As an associate, the investment would have been accounted for using the equity method and would be valued at $14.8 million as at 1 July 20X7:

	$'000
Cost	10,000
Share of increase in net assets between acquisition dates ($12m × 40%)	4,800
Investment in associate as at 1 July 20X7	14,800

The fair value of the original 40% interest would be $15.2 million (10m × 40% × $3.80) and so gain of $400,000 would be included within profit or loss.

Goodwill will be calculated at 1 July 20X7, the date that control is gained, as the difference between the fair value of the consideration and non-controlling interest and the fair value of the identifiable net assets at acquisition. The consideration must include the fair value of the original 40% equity interest as well as the fair value of the additional consideration.

The fair value of the non-controlling interest at 1 July 20X7 will be $11.4 million (10m × 30% × $3.80).

The fair value of the share exchange will be $9 million (3 million shares acquired × ½ × $6).

Goodwill has been determined to be $2,259,000 which means the cash paid to acquire Flour Co on 1 July 20X7 must be $3 million as follows:

	$'000
Fair value of original 40% equity interest	15,200
Fair value of share exchange	9,000
Fair value of non-controlling interest at acquisition	11,400
Fair value of identifiable net assets at acquisition including FV uplift ($35,741 + $600)	(36,341)
Cash Consideration (balancing figure)	3,000
Goodwill on acquisition per question	2,259

Cash paid to acquire Flour Co will be included within the investing activities of the consolidated statement of cash flows. However, the cash held by Flour Co will now be consolidated so a net outflow arises of $1,766,000 ($3m – $1.234m).

(b) **Extracts from the consolidated statement of cash flows for the Sugar Group year ended 30 June 20X8**

Cash flows from investing activities

	$'000
Net cash paid on acquisition of Flour Co (part (a))	(1,766)
Cash paid to acquire intangible assets (W1)	(12,051)
Proceeds from disposal of property plant and equipment (W2)	4,370
Cash paid on acquisition of Butter Co (given in question)	(5,000)
Dividends received from associates (W3)	2,253
Proceeds from disposal of FVTPL investment ($4m + $0.5m)	4,500
Investment income received (W4)	1,991

Cash flows from financing activities

	$'000
Issue of ordinary shares during the year (W5)	9,600
Dividends paid to the non-controlling interest (W6)	(3,324)

Workings

1 *Intangible assets*

	$'000
Intangible assets b/f	15,865
Goodwill on acquisition of Sugar Co	2,259
Licences and patents on acquisition of Sugar Co	6,781
Amortisation	(3,500)
Cash purchases of intangible assets (balancing figure)	12,051
Intangible assets c/f	33,456

2 *Property, plant and equipment*

	$'000
Property, plant and equipment b/f	52,818
Acquisition of Flour Co (at fair value)	18,676
Depreciation	(10,000)
Carrying amount of disposal (balancing figure)	(6,370)
Property, plant and equipment c/f	55,124

3 *Dividends received from associates*

	$'000
Investment in associates b/f	23,194
Associate profit for the year	15,187
Acquisition of Butter Co	5,000
Step acquisition Sugar Co (part (a))	(14,800)
Dividends received (balancing figure)	(2,253)
Investment in associate c/f	26,328

4 *FV gains recognised in investment income*

	$'000
FVTPL asset b/f	6,000
Carrying amount of disposal	(4,000)
Fair value gains included in investment income (balancing figure)	1,000
FVTPL asset c/f	3,000

	$'000
Investment income per PL	3,891
FV gains on FVTPL investments	(1,000)
Fair value gains on step acquisition	(400)
Profit on disposal of FVTPL	(500)
Investment income received	1,991

Proceeds from the disposal of the FVTPL asset are $4.5 million ($4m + $0.5m)

Tutorial note.

The fair value gain is included within investment income but is not a cash flow and so will be excluded from the consolidated statement of cash flows. In addition there is a $400,000 gain arising upon the step acquisition of Flour Co included within the investment income but isn't a cash flow. The profit on disposal of $0.5 million is also not a cash flow but forms part of the proceeds from the disposal of FVTPL assets within investing activities. Cash proceeds included within the investment income of the group are therefore $1,991,000.

5 *Issue of ordinary shares during the year*

	$'000
Share capital and share premium b/f ($20m + $18m)	38,000
Share for share exchange (part (a))	9,000
Cash proceeds from issue of shares during the year (balance)	9,600
Share capital and share premium c/f ($23m + $33.6m)	56,600

6 *Dividends paid to non-controlling interest*

	$'000
Non-controlling interest b/f	12,914
Added on acquisition of Flour Co (part (a))	11,400
Non-controlling interest profit for the year	9,162
Dividends paid to non-controlling interest (balancing figure)	(3,324)
Non-controlling interest c/f	30,152

(c) The only cash flow that should be recorded in the consolidated statement of cash flows in relation to defined benefit pension schemes are the contributions paid into the scheme. These are typically included within the operating activities of the group statement of cash flows. Since Sugar Co did not make any contributions until after the year-end there will be no cash flows to include in the consolidated statement of cash flows for the year ended 30 June 20X8. The $2 million benefits paid out of the scheme are a cash outflow but they are an outflow of cash from the pension scheme itself, a separate entity, rather than a cash outflow of Sugar Co.

This does not mean that the pension scheme will not have any impact upon the consolidated statement of cash flows of the Sugar group. Since operating activities are being calculated using the indirect method it is necessary to adjust for any items that effect operating profit but are not cash flows. This would include the service cost component which would need to be added back to group profits. Care would also need to be taken in calculating the interest paid in the year. The finance cost charge in the profit and loss would include the net interest charge from unwinding the opening value of the liabilities and the estimated return on the assets. Neither of these are cash flows and so would require adjusting. The remeasurement component is included as part of other comprehensive impact and will not impact on the group statement of cash flows since it is not a cash flow, nor does it impact upon operating profit.

16 Angel

Workbook reference. Group statements of cash flow are covered in Chapter 17. Interpretation of financial statements of different companies is included in Chapter 18.

Top tips. There are many straightforward, non-group aspects to this extracts from consolidated statement of cash flows question, so make sure you don't get bogged down in the information provided at the expense of these. We have set up workings for working capital reconciliations even though the movements are straightforward.

Make sure you allocate enough time to Part (b) – it has eight marks available for fairly straightforward knowledge that is not technically challenging.

Easy marks. These are available for the workings in Part (a)(iii) as well as explanations for the adjustments in Part (a), all of which are straightforward, along with valid points made in Part (b) on the differences between manufacturing and digital companies. The key point with cash flows is to ensure your understanding of the signage of each adjustment is clear, this will be important not only for your workings but also your explanation to the directors.

Marking scheme

			Marks
(a)	(i)	Building renovation	4
	(ii)	Profit before taxation	4
	(iii)	Cash generated from operations – up to 2 marks per item	14
(b)	(i)	Discussion 1 mark per point to a maximum	5
	(ii)	Discussion 1 mark per point for each non-financial disclosure to a maximum	3
			30

(a) (i) **Building renovation**

The building renovation has been incorrectly accounted for because Angel has debited the cash spent to revenue and this needs to be corrected in order to capitalise the correct amount for the enhancement of the asset. The correcting entries are:

Debit	Property, plant and equipment (PPE)	$3m	
Credit	Revenue		$3m

Being capitalisation of renovation of building and correction of charge to revenue

Angel treats grant income on capital-based projects as deferred income so it should not have credited the cash received from the grant to PPE and it needs to be reclassified to deferred income on the statement of financial position. The grant will then be released in line with future depreciation charges so as to recognise the benefit over the same period as the related costs it is intended to compensate. However, the grant of $2 million needs to be split equally between renovation (capital) and job creation (revenue). There do not appear to be any future performance conditions relating to the job creation portion of the grant, so that part may be released immediately to profit and loss at the time the cash has become receivable. The correcting entries for this are:

Debit	Property, plant and equipment (PPE)	$2m	
Credit	Retained earnings – profit or loss		$1m
Credit	Deferred income		$1m

Being correction of treatment of grant income

(ii) **Adjustments to profit before tax**

Profit before tax needs to be adjusted to take account of:

(1) The correcting entries for the building refurbishment and grant in Part (a)(i).

(2) The $4 million construction costs for the machine have been incorrectly charged to other expenses and need to be capitalised as part of property, plant and equipment (information point (iii)).

(3) The related interest of $1 million which is allowable as part of the cost of the asset under IAS 23 *Borrowing Costs* needs to be capitalised (information point (iii)):

Correcting entries for points (2) and (3) are:

Debit	Property, plant and equipment	$5m	
Credit	Profit or loss		$5m

Being correction of construction costs charged to operating expenses and capitalisation of interest under IAS 23.

Therefore, profit before tax may be adjusted as follows to arrive at a correct figure for inclusion in the cash flow statement:

	$m
Per question	184
Correction of renovation costs and grant (a)(i)	4
Correction of construction costs and interest (a)(ii)	5
	193

(iii) ANGEL GROUP

EXTRACT FROM STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 30 NOVEMBER 20X3

	$m
Operating activities	
Profit before tax (Part (a)(ii))	193.0
Adjustments for:	
Profit on sale of property, plant and equipment: (W1)	(14.0)
Depreciation (per question/W2)	29.0
Impairment of goodwill and intangible assets (per question/W3): $26.5m + $90m	116.5
Share of profit of associate (per question/W4)	(12.0)
Interest expense: $11m per question less $1m capitalised ((a)(ii) (W5)	10.0
	322.5
Decrease in trade receivables (W6)	58.0
Decrease in inventories (W6)	41.0
Decrease in trade payables (W6)	(211.0)
Cash generated from operations	210.5

Workings

1 *Profit on sale of property, plant and equipment (PPE)*

	$m
Proceeds from sale of PPE	63
Less carrying amount of PPE disposed	(49)
Profit on sale of property, plant and equipment	14

This amount needs to be deducted from profit before tax because the profit of $14 million is a non-cash credit currently included within profit before tax. The cash proceeds figure of $63 million will be included in the investing activities section.

2 *Depreciation*

The depreciation charge of $29 million which has been deducted in arriving at the profit before tax figure. It is non-cash and must be added back.

3 *Impairment of goodwill and intangible assets*

The impairment charge of $116.5 million, which has been deducted in arriving at the profit before tax figure, is a non-cash movement and, as with depreciation, it must be added back.

4 *Share of profit of associate*

The profit share of $12 million recorded in Angel's profit or loss is again a non-cash figure and should therefore be deducted to arrive at a cash figure related to operations. Any dividend received by Angel from its associate during the year will be included as a cash receipt in the investing activities section of Angel's cash flow statement.

5 *Interest expense*

The interest charge of $10 million (being the $11m paid less the $1m capitalised) is a cash payment. It is reclassified and shown in the cash flow statement below cash generated from operations as a charge to this figure, along with tax, to arrive at a net cash from operating activities figure.

6 *Working capital changes*

	Inventories	*Trade receivables*	*Trade payables*
	$m	$m	$m
b/d	190	180	361
Acquisition of subsidiary	6	3	5
∴ Increase/(decrease)	**(41) β**	**(58) β**	**(211) β**
c/d	155	125	155

Movements in working capital are brought into the cash generated from operations figure. If the inventories balance has fallen, there is less cash tied up in inventory held and the cash position benefits. The key point here is that Angel acquired a subsidiary, Sweety, during the financial year and gained inventory and trade receivable and payable balances without a related operational movement in cash. Therefore, these amounts must be adjusted when calculating the correct cash flow. The cash payment to acquire Sweety (net of the cash acquired) will be included in the investing activities section of the cash flow statement.

(b) (i) **Financial statement differences**

Angel is a wholesale manufacturer and has made an investment gaining significant influence in a digital company. It is important that the stakeholders of Angel, which includes is directors, manage their expectations in terms of the information presented in the financial statements of Digitool. At a high level, as a wholesale manufacturer, Angel will have a significant level of property, plant and equipment (a factory, a distribution warehouse and manufacturing machinery) and it will hold inventories either in the form of finished goods or work in progress. As a result of its long-established relationships with large customers, it would be expected to have a relatively high level of trade receivables. Contrast this with Digitool. Its non-current assets will comprise its data centre and related equipment. Digital companies also frequently invest in research and development relating to new techniques and processes and may therefore have significant capitalised development costs. It would not be expected to have inventory, other than some work in progress relating to any ongoing contracts,

In terms of the ratios commonly reviewed, it is important that ratios are reviewed in the context of the specific entity. It is unlikely that the directors will be able to compare the ratios they regularly review for Angel with equivalent ratios for Digitool. The gross profit margin will not be comparable between the companies. The cost of sales of Digitool will mainly comprise employee costs and therefore its gross profit margin is likely to be higher than that for Angel. Digitool will, however, have additional operating costs relating to research, and advertising and promotion expenditure incurred in generating new customers that Angel is unlikely to have, thus net profit margins may be more comparable. The return on capital employed is likely to be lower for Angel as it has been established for a number of years, has goodwill from its investments in other entities and is heavily capitalised. The inventory holding period is a very important ratio for a manufacturing company but is not relevant for a digital company as it does not hold a physical inventories and any work in progress would be expected to convert to revenue quickly. It is not clear what the credit terms offered to customers are, but given Angel has long-standing contracts with regular customers, it is likely to have a longer receivables collection period than Digitool which has a number of new contracts.

(ii) **Non-financial performance measures**

The non-financial performance measures reported by Digitool are in keeping with expectations for a digital company:

- Relationships with customers – it is essential for companies that do not sell a physical product and instead sell 'business solutions' to their customers to communicate well with their customers to understand their needs and be able to tailor solutions to them. Digitool may report factors such as customer satisfaction scores, the number of individual engagements with their customers in a period or the average number of repeat customers. Although traditional manufacturers must also have a customer focus to keep their products relevant, because Angel produces mass-produced furniture, it is less likely to interact with the final customer.
- Emissions levels – perhaps surprisingly, data centres produce large levels of emissions and digital companies come under the same social and political pressures to reduce emissions as heavy manufacturing companies.
- Investment in human capital – digital companies rely on their staff to be at the cutting edge of technological developments in order to keep them ahead of competitors. Companies compete to attract the best talent and are renowned for having creative working spaces, flexible working conditions and good salaries to ensure they are seen as good places to work. Traditional companies have requirements to pay staff fair rates and must comply with strict health and safety requirements, particularly when operating machinery, but will generally have a more traditional work environment.

17 Moyes

Marking scheme

				Marks
(a)	(i)	Calculation of cash flow generated from operations	6	
		Explanation of the adjustments and use of the scenario	6	
				12
	(ii)	Application of the following discussion to the scenario:		
		• Purchase consideration (shares and deferred cash)	1	
		• Impact on consolidated statement of cash flows of:		
		– Subsidiary acquisition (including dividend)	3	
		– Subsidiary disposal	2	
				6
	(iii)	IFRS 5 definition of discontinued operation and application to the scenario	3	
		Consideration of held for sale and application to the scenario	1	
		Consideration of loss of control and application to the scenario	2	
				6
(b)	Share-based payment			6
				30

(a) (i) **Explanatory note to: The directors of Moyes**

Subject: Cash generated from operations

	$
Profit before tax	209
Share of profit of associate	(67)
Service cost component	24
Contributions into the pension scheme	(15)
Impairment of goodwill	10
Depreciation	99
Impairment of property, plant and equipment ($43m – $20m)	23
Movement on inventory ($165m – $126m – $6m)	33
Loss on inventory	6
Increase in receivables	(7)
Increase in current liabilities	18
Cash generated from operations	333

Cash flows from operating activities are principally derived from the key trading activities of the entity. This would include cash receipts from the sale of goods, cash payments to suppliers and cash payments on behalf of employees. The indirect method adjusts profit or loss for the effects of transactions of a non-cash nature, any deferrals or accruals from past or future operating cash receipts or payments and any items of income or expense associated with investing or financing cash flows.

The share of profit of associate is an item of income associated with investing activities and so has been deducted. Likewise cash paid to acquire property, plant and equipment is an investing cash flow rather than an operating one. Non-cash flows which have reduced profit and must subsequently be added back include the service cost component, depreciation, exchange losses and impairments. With the impairment of property, plant and equipment, the first $20 million of impairment will be allocated to the revaluation surplus so only $23 million would have reduced operating profits and should be added back. In relation to the pension scheme, the remeasurement component can be ignored as it is neither a cash flow nor an expense to operating profits. Cash contributions should be deducted, though, as these represent an operating cash payment ultimately to be received by Moyes' employees. Benefits paid are a cash outflow for the pension scheme rather than Moyes and so should be ignored.

The movements on receivables, payables and inventory are adjusted so that the timing differences between when cash is paid or received and when the items are accrued in the financial statements are accounted for. Inventory is measured at the lower of cost and net realisable value. The inventory has suffered an overall loss of $6 million
(Dinar 80 million/5 – Dinar 60 million/6). Of this, $2.7 million is an exchange loss (Dinar 80 million/5 – Dinar 80 million/6) and $3.3 million is an impairment loss (Dinar (80 – 60) million/6). Neither of these are cash flows and would be added back to profits in the reconciliation. However, the loss of $6 million should also be adjusted in the movement of the inventory as a non-cash flow. The net effect on the statement of cash flows will be nil.

(ii) When the parent company acquires or sells a subsidiary during the financial year, cash flows arising from the acquisition or disposal are presented within investing activities. In relation to Davenport, no cash consideration has been paid during the current year since the consideration consisted of a share for share exchange and some deferred cash. The deferred cash would be presented as a negative cash flow within investing activities but only when paid in two years' time.

This does not mean that there would be no impact on the current year's statement of cash flows. On gaining control, Moyes would consolidate 100% of the assets and liabilities of Davenport which would presumably include some cash or cash equivalents at the date of acquisition. These would be presented as a cash inflow at the date of acquisition net of any overdrafts held at acquisition. Adjustments would also need to be made to the opening balances of assets and liabilities by adding the fair values of the identifiable net assets at acquisition to the respective balances. This would be necessary to ensure that only the cash flow effects are reported in the consolidated statement of cash flows. Fair value adjustments to assets and liabilities could also have deferred tax effects which would need adjusting so that only cash payments for tax are included within the statement of cash flows. Dividends received by Moyes from Davenport are not included in the consolidated statement of cash flows since cash has in effect been transferred from one group member to another. The non-controlling interest's share of the dividend would be presented as a cash outflow in financing activities.

On the disposal of Barham, the net assets at disposal, including goodwill, are removed from the consolidated financial statements. Since Barham is overdrawn, this will have a positive cash flow effect for the group. The overdraft will be added to the proceeds (less any cash and cash equivalents at disposal) to give an overall inflow presented in investing activities. Care would once again be necessary to ensure that all balances at the disposal date are removed from the corresponding assets and liabilities so that only cash flows are recorded within the consolidated statement of cash flows.

(iii) IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* defines a discontinued operation as a component of an entity which either has been disposed of or is classified as held for sale, and:

(i) Represents a separate major line of business or geographical area of operations;

(ii) Is a single co-ordinated plan to dispose of a separate major line or area of operations; and

(iii) Is a subsidiary acquired exclusively for resale.

Both entities would be components of the Moyes group since their operations and cash flows are clearly distinguishable for reporting purposes. Barham has been sold during the year but there appear to be other subsidiaries which operate in similar geographical regions and produce similar products. Little guidance is given as to what would constitute a separate major line of business or geographical area of operations. The definition is subjective and the directors should consider factors such as materiality and relevance before determining whether Barham should be presented as discontinued or not.

To be classified as held for sale, a sale has to be highly probable and the entity should be available for sale in its present condition. At face value, Watson would not appear to meet this definition as no sales transaction is to take place.

IFRS 5 does not explicitly extend the requirements for held for sale to situations where control is lost. However, the International Accounting Standards Board (IASB) has confirmed that in instances where control is lost, the subsidiaries' assets and liabilities should be derecognised. Loss of control is a significant economic event and fundamentally changes the investor – investee relationship. Therefore, situations where the parent is committed to lose control should trigger a reclassification as held for sale. Whether this should be extended to situations where control is lost due to other causes would be judgemental. It is possible therefore that Watson should be classified as held for sale but to be classified as a discontinued operation, Watson would need to represent a separate major line of business or geographical area of operation.

(b) **Share-based payment**

IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements). IFRS 13 specifically excludes transactions covered by certain other standards including share-based payment transactions within the scope of IFRS 2 *Share-based Payment*.

For cash settled share-based payment transactions, the fair value of the liability is measured in accordance with IFRS 2 initially, at each reporting date and at the date of settlement using an option pricing model. The measurement reflects all conditions and outcomes on a weighted average basis, unlike equity settled transactions. Any changes in fair value are recognised in profit or loss in the period. Therefore, the SARs should have been accounted for as follows:

Year	*Expense* $	*Liability* $	*Calculation*	
30 September 20X6	641,250	641,250	285 × 500 × \$9 × ½	Time-apportioned over vesting period. Using the estimated (300 × 95%) 285 managers.
30 September 20X7	926,250	1,567,500	285 × 500 × \$11	Expense is difference between liabilities at 30 September 20X7 and 30 September 20X6
30 September 20X8	97,500	1,350,000	225 × 500 × \$12	Cash paid is 60 × 500 × \$10.50, ie \$315,000. The liability has reduced by \$217,500 and therefore the expense is the difference of \$97,500

The fair value of the liability is $1,350,000 at 30 September 20X8 and the expense for the year is $97,500.

18 Hummings Co

Workbook references. Foreign operations and functional currency are covered in Chapter 16. Financial instruments are covered in Chapter 8.

Top tips. In part (a) you were required to explain how the functional currency of a subsidiary should be determined. As with all questions in SBR, you must make sure your answer is applied to the scenario given. In part (b)(i), your discussion should have covered both the recognition of the contracts as intangible assets as well as the covering the translation of the assets into the group's presentation currency. In part (b)(ii), make sure you do as the requirement asks - you only need to explain calculations where the requirement asks you to do so. Here the requirement asks you to explain the impact on the group accounts of the impairment and exchange difference on goodwill. It does not ask you to explain the calculation of goodwill, therefore don't waste your time doing this. Part (c) covered the accounting treatment of a subsidiary acquired for resale. With this type of question, a good approach is to explain the relevant requirements of the standard first, then apply those requirements to the scenario to reach a conclusion. Part (d) covered impairment of financial assets. This question was difficult, and the calculation of the loss allowance was particularly hard. In your real exam, you should not overrun on your allocated time for questions which are difficult such as this, ensure you answer as best you can in the time available, and then move on to the next question.

Marking scheme

				Marks
(a)	Application of the following discussion to the scenario:			
		Autonomy from parent	2	
		Determination of functional currency	3	
				5
(b)	(i)	Application of the following discussion to the scenario:		
		Identifiable criteria and recognition	3	
		Need to amortise	1	
				4
	(ii)	Goodwill calculation	4	
		Discussion of correct treatment of impairment and exchange difference	1	
		Recognition of split between shareholders	1	
				6
(c)	Discussion of asset held for sale criteria		2	
	Application of the above discussion to Quaver Co		2	
				4
(d)	Amortised cost identification		1	
	12-month credit loss – discussion		2	
	– calculation		1	
	Amortised cost calculation		1	
	Explanation lifetime credit losses		3	
	Calculation of lifetime credit losses		3	
				11
				30

(a) The functional currency is the currency of the primary economic environment in which the entity operates. With a foreign acquisition, consideration should be given as to whether Crotchet Co should adopt the same functional currency as its parent, Hummings Co. However, Crotchet Co appears to be largely independent and is not reliant on Hummings Co for either sales or finance. It is not required therefore for Crotchet Co to adopt the same functional currency as Hummings Co. Crotchet Co does not appear to have transactions in dollars or have a dollar bank account and it can be concluded that the dollar should not be their functional currency.

In determining its functional currency, Crotchet Co should consider the currency which mainly influences its sales price of goods and the currency which mainly influences its labour and other costs. This is likely to be the currency which goods are invoiced in and the currency in which costs are settled. The location of the entity's head office is irrelevant except to the extent that it is likely that the costs of running the head office are likely to be settled in the domestic currency. For Crotchet Co, whilst there are a number of transactions in dinars and tax has to be paid in dinars, it appears that the vast majority of their transactions are in grommits. All sales and purchases are invoiced in grommits as well as approximately half of their staff being paid in grommits. Funds for finance are raised in grommits which further suggests that grommits should be chosen as the functional currency of Crotchet Co.

(b) (i) IFRS 3 *Business Combinations* requires the investor to identify all of the investee's identifiable net assets at acquisition. To be identifiable, a customer contract must either be capable of being used or sold separately or it must arise from legal or contractual rights. A reliable estimate of its fair value is also necessary to be recognised as a separate asset rather than subsumed within the goodwill figure. This is the case regardless of whether the contracts had been recognised within the individual financial statements of Crotchet Co or not.

The contracts provide Crotchet Co with a legal right to prevent their customers from obtaining goods and services from their competitors and a reliable estimate of fair value appears to be obtainable. The contracts should be recognised as a separate intangible asset at an initial value of 15 million grommits. This would initially be translated at the spot rate of exchange of $1 to 8 grommits and would be recognised initially in the consolidated financial statements at $1.875 million. The contracts would need to be examined to determine the average unexpired useful life of the contracts and amortised over this period. This would be translated at the average rate of exchange and expensed to consolidated profit or loss. The carrying amount of the contracts would need to be retranslated at the closing rate of exchange of $1 to 7 grommits ($2.143 million) with a corresponding exchange gain recognised within equity.

(ii) Goodwill at 31 December 20X4 would be $8.2 million calculated as follows:

	Grommits (millions)	*Ex rate $:grommits*	*$ (millions)*
Consideration ($24m × 8)	192		
NCI at acquisition ($6m × 8)	48		
Net assets at acquisition*	(158)		
Goodwill at 1 January 20X4	82	8	10.25
Impairment (30%)	(24.6)	7	(3.51)
Exchange gain			1.46
	57.4	7	8.2

* Net assets at acquisition are 43 million grommits plus 15 million grommits for the contractual relationships plus 100 million grommits for the dinar assets translated at 1 dinar to 2 grommits (50m × 2).

Goodwill is initially recognised at the spot rate of exchange of $1:8 grommits and so would initially be $10.25 million. The impairment loss of $3.51 million will be expensed against consolidated profit or loss. Goodwill will be retranslated using the closing rate of exchange of $1:7 grommits with the exchange gain of $1.46 million included within other comprehensive income. Since non-controlling interest is valued at fair value, both the impairment and the exchange gain will be apportioned 80/20 between the shareholders of Hummings Co and the non-controlling interest respectively.

(c) It appears as if the acquisition of Quaver Co should be treated as a subsidiary acquired exclusively with a view for resale. The usual criteria for an asset to be classified as held for sale as per IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* include:

- The sale must be highly probable;
- The sale must be expected to be complete within 12 months;
- The asset must be actively marketed at a reasonable price;
- Management must be committed to a plan of sale and it is unlikely that any significant changes to the plan will be made.

The sale has not taken place within 12 months of acquisition; however, an exception is permitted where the sale is still deemed to be highly probable and the delay was caused by events which were unforeseen and beyond the control of management. The sale is still expected early in 20X5 and the legal dispute was unforeseen, so this exception seems applicable.

It appears clear that management was immediately committed to the sale as Hummings Co did not wish to have active involvement in the activities of Quaver Co. Quaver Co should therefore be treated as a subsidiary acquired exclusively with a view to resale. It should not be consolidated into the Hummings group financial statements. Quaver Co should initially be valued at fair value less costs to sell with any subsequent decreases in fair value less costs to sell taken to consolidated profit or loss. As a subsidiary acquired exclusively for resale, Quaver Co would be classified as a discontinued activity and earnings for the year disclosed separately in the consolidated statement of profit or loss of the Hummings group.

(d) Since the business model of Hummings Co is to collect the contractual cash flows of the bonds over the life of the asset, the bonds should be measured at amortised cost. All financial assets including amortised cost assets should initially be recognised at fair value. This would be equal to the $10,000,000 paid on acquisition of the bonds.

IFRS 9 *Financial Instruments* requires entities to adopt an expected value approach to the consideration of impairment losses on financial assets. On acquisition, the bonds are considered low risk and are not credit impaired. The bonds would be classified as a stage one financial asset as at 31 December 20X3. This means that Hummings Co should create an expected credit loss equal to 12 months expected credit losses. It is important to appreciate that the 12-month expected credit loss is not the lifetime expected credit loss which an entity will incur which it predicts will default in the next 12 months. The 12-month expected credit loss is defined as a portion of the lifetime expected credit losses which represent the expected credit losses which result from a default within the next 12 months. In effect, the proportion of the lifetime expected credit losses which are expected should a default occur within 12 months are weighted by the probability of a default occurring. Hummings Co should therefore recognise a default allowance of $10,000 as at 31 December 20X3. This will be expensed to profit or loss and a separate allowance created rather than offset against the $10,000,000 bonds. The allowance is, however, netted off the $10,000,000 bond in the statement of financial position of Hummings Co as at 31 December 20X3. The carrying amount of the bonds in the statement of financial position at 31 December 20X3 will be $9.99 million ($10 million – $10,000).

As the bonds are to be measured at amortised cost, the effective rate of interest of 8% will be included in profit or loss and added to the bonds. This is calculated on the initial $10,000,000 and is not affected by the loss allowance of $10,000. The coupon interest of $500,000 ($10,000,000 × 5%) is deducted from the carrying amount of the bonds. This means that the bonds would have a carrying amount of $10,300,000 at 31 December 20X4 before considering the impairment allowance.

B/fwd	*Interest 8%*	*Coupon 5%*	*C/fwd*
$	PL		
10,000,000	800,000	(500,000)	10,300,000

At 31 December 20X4, there has been a significant increase in credit risk. As no actual default has yet occurred, the bonds should be classified as a stage two financial asset. This means that Hummings Co should make an allowance to recognise the lifetime expected credit losses. This is defined as the expected credit losses (cash shortfalls) which result from all possible default events over the expected life of the bonds. An allowance is required equal to the present value of the expected loss in contractual cash flows as weighted by the probability of default. The expected default losses are discounted using the original effective rate of interest of 8%.

Date	*Cash flow loss working*	*PV of default*
		$
31 December 20X5	3% × $462,963	13,889
31 December 20X6	5% × $6,858,710	342,936
		356,825

The expected loss allowance should be increased to $356,825 with an expense recorded in profit or loss of $346,825 ($356,825 – $10,000). The loss allowance is deducted directly from the bonds with future interest income recorded on the gross position. The carrying amount of the bonds at 31 December 20X4 would be $9,953,175 ($10,300,000 – $346,825).

19 Carbise

Workbook references. The underlying principles of IFRS 3 are covered in Chapter 11. Disposals of interests in investments are covered in Chapter 14. Foreign transactions and foreign entities are covered in Chapter 16.

Top tips. In part (a), you must make sure that you apply your knowledge to the scenario given: the examiner's report stated that weaker answers to this question tended to list the factors determining the functional currency, with little application to the scenario. Remember that there are very few marks available for stating knowledge, you must apply your knowledge to the scenario to gain the majority of the marks available.

In questions like this where complex calculations are required, the examiner has advised that you produce your calculation on one sheet of paper and simultaneously explain the calculation on another sheet of paper. This way of producing an answer will help you to explain each part of a calculation as you perform it, enabling you to generate as many marks as possible.

Marking scheme

				Marks
(a)	(i)	Discussion of presentation and functional currency	2	
		Application of the above discussion to the scenario	5	
				7
	(ii)	Calculation of goodwill	2	
		Calculation of the exchange difference on goodwill	3	
				5
	(iii)	Explanation of the goodwill calculation and application to the scenario	2	
		Explanation of the exchange gain and application to the scenario	2	
				4
(b)		Explanation of Bikelite exchange differences	3	
		Calculation of Bikelite exchange differences for y/e 20X6:		
		Translation	3	
		Split between parent and NCI	1	
				7
(c)	(i)	Calculation of group profit or loss on disposal		3
	(ii)	Explanation of the accounting treatment of Bikelite		4
				30

(a) **Explanatory note to: Directors of Carbise**

Subject: Foreign subsidiary Bikelite

(i) The presentation currency is the currency in which the financial statements are presented. IAS 21 *The Effects of Changes in Foreign Exchange Rates* permits an entity to present its individual financial statements in any currency. It would therefore be up to the directors of Bikelite to choose a presentation currency for its individual financial statements. Factors which could be considered include the currency used by major shareholders and the currency in which debt finance is primarily raised.

The functional currency is the currency of the primary economic environment in which the entity operates. Since transactions are initially recorded in an entity's functional currency, the results and financial position would need to be retranslated where this differed to the presentation currency.

When determining the presentation and functional currency of Bikelite, consideration should first be given to whether the functional currency of Bikelite should be the same as Carbise, at least whilst under the control of Carbise. It appears that Bikelite has considerable autonomy over its activities. Despite being acquired to make more efficient use of the surplus inventory of Carbise, purchases from Carbise were only 5% of Bikelite's total purchases. Revenue is invoiced in a range of currencies suggesting a geographically diverse range of customers which, although this allows Carbise access to new international markets, is unlikely to be classified as an extension of the parent's operations. The volume of the transactions involved between Carbise and Bikelite would seem to be far too low to come to this conclusion. Bikelite also appears free to retain cash in a range of currencies and is not obliged to remit the cash to Carbise in the form of dividends. Nor does Bikelite appear to be dependent on financing from Carbise with other investors taking up the bond issue at the start of 20X6. The functional currency of Bikelite does not need to be the same as Carbise.

In choosing its functional currency, Bikelite should consider the following primary factors: the currency which mainly influences the sales price for their goods, the currency of the country whose competitive forces and regulations determine the sales price and also the currency which influences labour, material and overhead costs. The key determinant here is the currency which the majority of the transactions are settled in. Bikelite invoices and is invoiced in a large range of currencies and so it would not be immediately clear as to the appropriate functional currency. Nor is there detail about whether there is a currency in which competitive forces and regulations could be important. We do not know, for example, what currency Bikelite's major competitors invoice in.

Secondary factors including the currency in which financing activities are obtained and the currency in which receipts from operating activities are retained can help guide the entity where it is not immediately clear. In relation to Bikelite, a significant volume of their sales are invoiced in dinars and the majority of their expenses too, given that wages and overheads are also paid in dinars. Funds were raised in dinars from the bond issue and so it would appear that the dinar should probably be the functional currency for Bikelite. It is also possible that Bikelite may lose their autonomy on Carbise' s sale of their shares which could have implications for the determination of the functional currency.

(ii) Goodwill in dinars on the acquisition of Bikelite would be dinar 42 million calculated as follows:

	Dinars millions
Consideration	100
FV of NCI	22
Less net assets at acquisition (60 + 20)	(80)
Goodwill at acquisition	42

On acquisition, the goodwill in \$ would be (dinar 42m/0.5) \$84 million.

Goodwill at 30 September 20X6 would be:

	Dinars millions	*Rate*	*\$m*
Goodwill at 1 January 20X2	42	0.5	84
Impairment y/e 31 December 20X5	(6)	0.4	(15)
Exchange gain			25.7 (bal)
Goodwill at 31 December 20X5	36	0.38	94.7
Current year exchange gain			8.2 (bal)
Goodwill at 30 September 20X6	36	0.35	102.9

Workings

Dinar impairment of 6 million is translated at the average rate of $1:0.4 dinar = $15 million.

Goodwill at 31 December 20X5 would be translated at last year's closing rate of $1:0.38 dinar = $94.7m.

Goodwill at 31 September 20X6 will be translated at $1:0.35 dinar = $102.9m.

(iii) On a business combination, goodwill is calculated by comparing the fair value of the consideration plus non-controlling interests (NCI) at acquisition with the fair value of the identifiable net assets at acquisition. Carbise measures NCI using the fair value method. This means that goodwill attributable to the NCI is included within the overall calculation of goodwill. An adjustment of dinar 20 million is required to the property of Bikelite to ensure the net assets at acquisition are properly included at their fair value.

At each year end, all assets (and liabilities) are retranslated using the closing rate of exchange. Exchange differences arising on the retranslation are recorded within equity. Since the non-controlling interest is measured under the fair value method, the exchange difference would be apportioned 80%/20% between the owners of Carbise and the non-controlling interest. Only the current year's exchange difference would initially be recorded within other comprehensive income for the year ended 31 December 20X6 whereas cumulative exchange differences on goodwill at 30 September 20X6 would be recorded within equity.

(b) The net assets of Bikelite would have been retranslated each year at the closing rate of exchange. There is therefore an exchange difference arising each year by comparing the opening net assets at the opening rate of exchange with the opening net assets at the closing rate of exchange. An additional exchange difference arises through the profit or loss of Bikelite each year being translated at the average rate of exchange in the consolidated statement of comprehensive income. The profit or loss will increase or decrease the net assets of Bikelite respectively which, as is indicated above, will be translated at the closing rate of exchange within the consolidated statement of financial position. As with goodwill, the exchange differences are included within equity with 80% attributable to the shareholders of Carbise and 20% to the NCI. Cumulative exchange differences will be included within the consolidated statement of financial position with just current year differences recorded within other comprehensive income.

The carrying amount of the net assets of Bikelite on 1 January 20X6 was dinar 48 million. The fair value of their opening net assets therefore would be dinar 64 million (dinar 48 + 16/20 × dinar 20 million). Bikelite would only be consolidated for the first nine months of the year since Carbise loses control on 30 September 20X6. Losses per the individual accounts for the year ended 31 December 20X6 were dinar 8 million, so only dinar 6 million would be consolidated. Additional depreciation of dinar 0.75 million (dinar 20m/20 × 9/12) would be charged for the first nine months of the year. Net assets at disposal in dinars would therefore be dinar 57.25 million (dinar 64 – dinar 6.75). The exchange difference arising in the statement of comprehensive income for the year ended 31 December 20X6 would be $13.4 million calculated as follows:

	$m
Opening net assets at opening rate (dinar 64/0.38)	168.4
Loss for 9 months at average rate (dinar 6.75/0.37)	(18.2)
Current year exchange gain (balance)	13.4
Net assets at 30 September 20X6 (dinar 57.25/0.35)	163.6

$10.7 million of the exchange differences are attributed to the shareholders of Carbide (80% × $13.4) and $2.7 million to the NCI.

(c) (i) **Group profit or loss on disposal on Bikelite**

	$m
Proceeds	150
Net assets at disposal (see (b))	(163.6)
Goodwill at disposal (see (a)(ii))	(102.9)
NCI at disposal	48.5
Exchange gains recycled to profit and loss	76.6
Group profit on disposal	8.6

Workings

Exchange gains at 1 January 20X6 per question are $74.1 million. Current year exchange differences on goodwill are $8.2 million (see (b)(i)) and on the net assets are $13.4 million (see (b)). Cumulative exchange gains at 30 September 20X6 are therefore $95.7 million. On disposal, the parent's share (80%) = $76.6 million should be recycled to profit or loss.

NCI at disposal is calculated as follows:

	$m
NCI at 1 January 20X6 per question	47.8
NCI share of loss to 30 September 20X6 (20% × dinar 6.75m (see (b))/0.37)	(3.6)
NCI share exchange gains for 9 months to 30 September 20X6 (20% × (13.4 + 8.2))	4.3
NCI at 30 September 20X6	48.5

(ii) For the year ended 31 December 20X6, Carbise will consolidate Bikelite for the first nine months of the year up to the date of disposal of the shares and subsequent loss of control. NCI will be calculated on the first nine months of losses. Exchange differences on the translation of the net assets, profits and goodwill in relation to the nine months to 30 September 20X6 will initially be recognised in other comprehensive income classified as gains which will be reclassified subsequently to profit or loss.

On 30 September 20X6, a consolidated profit or loss on disposal will be calculated in the consolidated financial statements of Carbise. In effect, the proceeds are compared to the net assets and unimpaired goodwill not attributable to the non-controlling interest at the disposal date. The cumulative exchange differences on the translation of Bikelite would be reclassified to profit or loss.

Consideration should be given as to whether the disposal of Bikelite would constitute a discontinued operation. For Bikelite to be classified as a discontinued operation, it would need to represent a separate major line of business or geographical area of operations. Since Bikelite was initially acquired by Carbise to gain easier access to international markets, it is likely that the criterion would be met.

20 Bagshot Co

Workbook references. Ethics and related parties are covered in Chapter 2. Restructuring provisions are covered in Chapter 6.

Top tips. In part (a)(i), you were asked to discuss the required accounting treatment of some restructuring costs. Make sure you read the question carefully to address all the points given in the scenario - eg the different types of costs mentioned and the timing of the announcement. Part (a)(ii) was best answered as two sub-requirements: a discussion of what good stewardship means, and then whether the proposed restructuring and accounting for the restructure constituted good stewardship. In part (a)(iii), a good approach would have been to identify the requirements of IAS 24 *Related Party Disclosures* as to the definition of a related party, then apply that definition to the facts of the scenario before reaching your conclusion.

In part (b), as well as discussing the ethical issues, you also needed to discuss the actions Mr Shaw should take. Make sure you cover both of these requirements in your answer. Question 2 of the exam will always feature ethical issues. Two professional marks are available for the application of ethical principles to the scenario given. Quoting ethical guidance will not be enough, you must apply that guidance to the scenario.

Marking scheme

				Marks
(a)	(i)	Discussion of IAS 37 criteria and restructuring expenditure	2	
		Application of the above to the scenario	3	
		Identification of non-adjusting event	1	
				6
	(ii)	Application of the following discussion to the scenario:		
		What is meant by good stewardship	2	
		Examples of good stewardship	2	
				4
	(iii)	Application of the following discussion to the scenario:		
		Control/significant influence criteria	2	
		Recognition of close family member	1	
				3
(b)	Application of the following discussion to the scenario:			
		Intimidation threat	1	
		Insider trading	2	
		Confidentiality	2	
				5
	Professional marks			2
				20

(a) (i) A provision for restructuring costs should only be recognised in the financial statements of Bagshot Co where all of the following criteria are met:

- A reliable estimate can be made of the amount of the obligation;
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation;
- There is a present obligation as a result of a past event.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that it would be extremely rare that no reliable estimate can be made. A best estimate of the expenditure required to settle the present obligation should be provided as at 31 December 20X5 should all criteria be met. In the case of a restructuring provision, this should only include direct expenditure arising from the restructuring and not associated with ongoing activities. Hence the relocation costs would not be included as, although they relate directly to the restructuring, the costs would be classified as an ongoing activity.

An obligation is regarded as probable where the event is more likely than not to occur. It is not clear that the restructuring is probable. Mrs Dawes has indicated that alternative strategies are possible and further clarification would be required to ascertain whether these activities would constitute a restructuring as per IAS 37. Only then may it be determined that a restructuring is indeed probable.

A constructive obligation for restructuring only arises where a detailed formal plan exists and a valid expectation to those affected by the restructuring that it will take place has occurred. A plan is in place but management does not yet appear committed as alternative strategies are possible. It is unlikely therefore that the plan is detailed and specific enough for these criteria to be satisfied. For example, the specific expenditure to be incurred, the date of its implementation and timeframe which should not be unreasonably long must be identified. With alternative strategies available, this does not appear to be the case. Furthermore, Mr Shaw is the only member of staff who has been notified and no public announcement has been made as at the reporting date. Consequently, there is no obligation in existence as at 31 December 20X5 and no provision can be recognised.

Mrs Dawes has identified that a final decision on the restructuring and communication is likely to take place before the financial statements are authorised. This would almost certainly be a material event arising after the reporting date but should be treated as non-adjusting. Accordingly, Bagshot Co should disclose the nature of the restructuring and an estimate of its financial effect but recognition of a restructuring provision is still prohibited.

(ii) Stewardship is an ethical principle which embodies the responsible planning and management of resources. The directors of Bagshot Co perform a stewardship role in that they are appointed by the shareholders to manage Bagshot Co on their behalf. The directors therefore assume responsibilities to protect the entity's resources from unfavourable effects of economic factors such as price and technological changes and to ensure that Bagshot Co complies with all laws, regulations and contractual obligations. Group results have been disappointing in recent years although no specific causes have been identified. It could be argued, therefore, that the restructure is acting in good faith and reflecting good principles of stewardship. It is anticipated that long-term shareholder value will be enhanced from the proposals.

A second factor of good stewardship is that it is important that investors, both existing and potential, and lenders have reliable and accurate information about the entity's resources so that they can assess how efficiently and effectively the entity's management and governing board have discharged their responsibilities. It is important therefore that the financial statements are transparent, objective and comply fully with International Financial Reporting Standards. Mrs Dawes wants Bagshot Co to include a restructuring provision as at 31 December 20X5 even though no obligation arises. Whilst prudence is a guiding principle when dealing with issues of uncertainty, excessive prudence cannot be justified. As a qualified member of ACCA, it should be apparent to Mrs Dawes that no provision should be recognised and to include one would be misleading to the stakeholders of Bagshot Co.

(iii) Mrs Shaw's acquisition of the equity shares in Bagshot Co would be deemed a related party transaction if the acquisition enabled her to control or have significant influence over Bagshot Co. A 5% ownership would not give Mrs Shaw control over the operating decisions of Bagshot Co and it is clear she would not be able to control the entity. Significant influence is the power to participate in the financial and operating decisions of the entity. It is presumed that a holding of less than 20% of the voting power is insufficient for significant influence unless this can be clearly demonstrated. Mrs Shaw is unaware of the proposed restructure which would suggest that she does not have a board position. It can be concluded that she does not have control nor significant influence.

Mrs Shaw would be deemed to be a close family member of Mr Shaw. She would therefore be deemed to be a related party if it was concluded that Mr Shaw is a member of key management personnel of Bagshot Co. Mr Shaw is the head accountant of Bagshot Co but it seems highly unlikely that he would be deemed to be key management personnel. There is no evidence that he has authority or responsibility for planning, directing and controlling the activities of Bagshot Co.

Nor does he appear to be a director of the entity. It can be concluded that Mrs Shaw's acquisition of the 5% of the equity in Bagshot Co would not be a related party transaction.

(b) Mr Shaw is facing a number of ethical dilemmas arising from the scenario. Mrs Dawes's insistence that a restructuring provision should be included could constitute an intimidation threat although her motivation for including the provision early is unclear. Mr Shaw is also a qualified member of ACCA and therefore should be aware that the treatment is inconsistent with international accounting standards. Mr Shaw must adhere to the ACCA *Code of Ethics* and prepare financial statements diligently which are objective and fully comply with International Financial Reporting Standards. He must not comply with Mrs Dawes's requests and should politely remind her of her professional responsibilities as a member of ACCA. Non-compliance with accounting standards would be a breach of a range of ethical principles including professional competence, professional behaviour and objectivity. Assuming that Mrs Dawes is aware of the error, her integrity would also be questionable.

Mr Shaw could be accused of insider trading were he to inform his wife of the proposed restructure. Insider trading involves the use of non-publicised information in order to make decisions on financial investments based on the information which others do not yet know about. It is clear that such behaviour would not be ethical since Mrs Shaw would be in an advantageous position to make investment decisions which could impact unfairly on the other shareholders. Insider traders have information which others do not have such that the other stakeholders may act differently and make different decisions should they have been privy to the same information. Such activities are seen as fraudulent and are likely to be in breach of local money laundering regulations.

Mr Shaw has become privy to confidential information regarding Bagshot Co. One of ACCA's key ethical principles is that of confidentiality. Information must not be disclosed to others unless there is a legal or professional right or duty to disclose. Professional accountants must also ensure that they do not use confidential information for their own personal benefit. Mr Shaw has self-interest threats arising both from his wife's ownership of the shares and from his nephew facing potential redundancy. His wife could use the information to consider whether she may wish to sell her 5% ownership interest. Mr Shaw may also feel pressure to inform his nephew of the potential redundancy he may be facing. This may allow his nephew to obtain an unfair advantage over fellow employees by, for example, examining other opportunities in the labour market. Mr Shaw must not disclose the confidential information to his wife or his nephew.

21 Calibra Co

Marking scheme

			Marks
(a)	Application of the following discussion to the scenario:		
	• Revenue IFRS 15	3	
	• Borrowing costs IAS 23	2	
			5
(b)	Journal entries		3
(c)	Discussion and application of ethical principles to scenario		10
Professional marks			2
			20

(a) The performance obligation will be satisfied upon the completion of construction which is also when the title, possession and control of the apartment block pass to the customer. The advanced payment represents a significant financing component and IFRS 15 *Revenue from Contracts with Customers* states that where this is the case then revenue is recognised at an amount that reflects the price that a customer would have paid if the customer had paid cash when they transfer the goods to the customer. IFRS 15 also states that the interest rate used should reflect the credit characteristics of the party receiving financing but may be the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash. In this case, the interest rate would be 6%. Using this rate, the cash sales price of $9.55 million can be discounted to $8.5 million. Calibra Co should recognise a liability of $8.5 million and should subsequently accrue interest on this liability balance for two years until it reaches $9.55 million when the performance obligation is satisfied.

The interest should be accounted for in accordance with IAS 23 *Borrowing* Costs as part of the cost of constructing the apartment block. As Calibra Co's business model is based on construction, IAS 23 states that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset and, therefore, in this case should be included in the cost of inventory production. Other borrowing costs are recognised as an expense.

(b) **Journal entries**

	Dr ($m)	*Cr* ($m)
Cash	8.5	
Liability		8.5
Records liability on receipt of cash (1/1/X8)		
Inventory: Interest accruing to 31/12/X8	0.51	
Liability		0.51
Interest accruing on liability to 31/12/X8 (6% × 8.5m) included in the costs of inventory		
Inventory: Interest accruing to 31/12/X9	0.54	
Liability		0.54
Interest accruing on liability to 31/12/X9 (6% × (8.5 + 0.51)) included in the costs of inventory		
Liability	9.55	
Revenue		9.55
Revenue arising on sale of apartment block (per question)		

The balance on the contract liability at 31/12/X8 would be $9.55 million (8.5 + 0.51 + 0.54). When control passes to the customer, Calibra Co recognises revenue of $9.55 million.

(c) The chief accountant should not hold himself out as having an understanding of distributed ledgers if he only has a basic knowledge. He should have seen evidence of whether the technology can be scaled up to the requirements of the directors before promising them that he can facilitate the move. Also, he must convince himself that the reliability of the due diligence on the sale of property shares and that local regulations are complied with. In order to maintain integrity, professional accountants must be honest about whether they are comfortable with their knowledge of managing projects such as this. The chief accountant should not manage the project if he has doubts as to his knowledge as there may be significant issues as the project progresses. There may be a need to engage specialist consultancy input from distributed ledger experts. Similarly, the chief accountant should behave in a professional manner and determine whether the data on the distributed ledger breaks any confidentiality principles. He will need to consider the fact that local regulations may be violated and the repercussions thereof. The technology allows resale of the shares in the property and given the chief accountants worries over due diligence, illegal transfers of title ownership could be costly and time consuming to resolve. The chief accountant must also exercise independence of mind and not bow to political pressure from the board even though it may be a high-profile project for the company. He should inform the board of his reservations based upon his opinion and technical knowledge.

One of the main concerns for accounting professionals is the fear of losing objectivity in their judgment due to pressures from clients, employers, or other stakeholders. This occurrence would create a loss of professional identity for the person concerned. Some individuals are more vulnerable to loss of objectivity than others. Young accountants at the beginning of their career could be considered a vulnerable group, as they may be more easily influenced due to a perceived lack of experience and pressures from senior colleagues. The accountant has only just qualified and so might be inexperienced to be in the position of chief accountant. In this case, he has created a self-interest threat as the chief accountant has a personal interest in allowing Bodoni Co to pay the reduced amount one month after the contract for the purchase of the apartment block has been signed, as he wishes a good reference from the client when he applies for the permanent position. The pressure of applying for this position has inappropriately influenced his professional judgement and behaviour. Additionally, there is a threat to the chief accountant's objectivity which stems from a self-interest threat from the fear of losing Bodoni Co as a client which in turn would affect the accountant's chances of securing his position on a permanent basis.

22 Farham

Marking scheme

			Marks
(a)	Application of the following discussion to the scenario:		
	Factory subsidence as an indication of impairment	2	
	Fair value	2	
	Allocation of impairment loss	1	
	Sale of Newall – HFS criteria, valuation and impairment	4	
	Required accounting treatment of the expected costs of sale	2	
			11
(b)	Discussion of ethical principles	2	
	Application of ethical principles to the scenario	5	
			7
Professional marks			2
			20

(a) **Factory subsidence**

The subsidence is an **indication of impairment** in relation to the production facility. Consideration would be required to choose a suitable cash-generating unit as presumably the factory would not independently generate cash flows for Farham as a standalone asset. The facility is likely to consist of both the factory and various items of plant and machinery and so it would not be possible to independently measure the cash flows from each of the assets. The recoverable amount of the unit would need to be assessed as the higher of fair value less costs to sell and value in use. Reference to IFRS 13 *Fair Value Measurement* would be required in estimating the fair value of the facility. For example, by considering whether similar facilities have been on the market or recently sold. Value in use would be calculated by estimating the present value of the cash flows generated from the production facility discounted at a suitable rate of interest to reflect the risks to the business. Where the carrying amount exceeds the recoverable amount, an impairment has occurred. Any **impairment loss** is allocated to reduce the carrying amount of the assets of the unit. This will be expensed in profit or loss and cannot be netted off the revaluation surplus as the surplus does not specifically relate to the facility impaired. **No provision for the repair to the factory** should be made because there is no legal or constructive obligation to repair the factory.

Sale of Newall

The disposal of Newall appears to meet the **held for sale criteria**. Management has shown commitment to the sale by approving the plan and reporting it to the media. A probable acquirer has been found in Oldcastle, the sale is highly probable and expected to be completed six months after the year end, well within the 12-month criteria. Newall would be treated as a disposal group since a single equity transaction is the most likely form of disposal. Should Newall be deemed to be a separate major component of business or geographical area of the group, the losses of the group should be presented separately as a discontinued operation within the consolidated financial statements of Farham.

Assets held for sale are valued at the **lower of carrying amount and fair value less costs to sell**. The carrying amount consists of the net assets and goodwill relating to Newall less the non-controlling interest's share. Assets within the disposal group which are not within the scope of IFRS 5 *Assets Held for Sale and Discontinued Operations* are adjusted for in accordance with the relevant standard first. This includes leased assets and it is highly likely that the leased asset deemed surplus to requirements should be written off with a corresponding expense to profit or loss. Any further impairment loss recognised to reduce Newall to fair value less costs to sell would be allocated first to goodwill and then on a pro rata basis across the other non-current assets of the group.

The chief operating officer is wrong to exclude any form of restructuring provision from the consolidated financial statements. The disposal has been communicated to the media and a constructive obligation exists. However, only **directly attributable costs of the restructuring** should be included and not ongoing costs of the business. **Future operating losses** should be excluded as no obligating event has arisen and no provision is required for the impairments of the owned assets as they would have been accounted for on remeasurement to fair value less costs to sell. The legal fees and redundancy costs should be provided for. The early payment fee should also be provided for despite being a future operating loss. This is because the contract is onerous and the losses are consequently unavoidable. A provision is required for $13 million ($2 million + $5 million + $6 million). The $6 million will be offset against the corresponding lease liability with only a net figure being recorded in profit or loss.

(b) **Ethics**

Accountants have a duty to ensure that the financial statements are **fair, transparent and comply with accounting standards**. The accountant appears to have made a couple of mistakes which would be unexpected from a professionally qualified accountant. In particular, the accountant appears unaware of which costs should be included within a restructuring provision and has failed to recognise that there is no obligating event in relation to future operating losses. Accountants must carry out their work with **due care**

and attention for the financial statements to have credibility. They must therefore ensure that their knowledge is kept up to date and that they do carry out their work in accordance with the relevant ethical and professional standards. Failure to do so would be a breach of **professional competence**. The accountant must make sure that they address this issue through, for example, attending regular training and professional development courses.

There are a number of instances which suggest that the chief operating officer is happy to **manipulate** the financial statements for their own benefit. She is not willing to account for an impairment loss for the subsidence despite knowing that this is contrary to IFRSs. She is also unwilling to reduce the profits of the group by properly applying the assets held for sale criteria in relation to Newall nor to create a restructuring provision. All of the adjustments required to ensure the financial statements comply with IFRS will reduce profitability. It is true that the directors do have a responsibility to run the group on behalf of their shareholders and to try to maximise their return. This must not be to the detriment, though, of producing financial statements which are **objective** and **faithfully represent** the performance of the group. It is likely that the chief operating officer is motivated by bonus targets and is therefore unfairly trying to misrepresent the results of the group. The chief operating officer must make sure that she is not unduly influenced by this **self-interest threat**.

The chief operating officer is also acting unethically by threatening to dismiss the accountant should they try to correct the financial statements. It is not clear whether the chief operating officer is a qualified accountant but the ethical principles should extend to all employees and not just qualified accountants. **Threatening and intimidating behaviour** is unacceptable and against all ethical principles. The accountant faces an **ethical dilemma**. They have a duty to produce financial statements which are objective and fair but to do so could mean that they lose their job. The accountant should approach the chief operating officer and remind them of the basic ethical principles and try to persuade them of the need to put the adjustments through the consolidated accounts so that they are fair and objective. Should the chief operating officer remain unmoved, the accountant may wish to contact the ACCA ethical helpline and take legal advice before undertaking any further action.

23 Gustoso

Marking scheme

		Marks
Application of the following discussion to the scenario:		
• Provision	3	
• Restructuring	5	
• Contract	3	
		11
Application of the following discussion of ethical issues to the scenario:		
• User expectations	1	
• Nature of errors/bias/intimidation	3	
• Advice to accountant	3	
		7
Professional skills marks		2
		20

Provision

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that a provision should only be recognised if:

- There is a present obligation from a past event;
- An outflow of economic resources is probable; and
- The obligation can be measured reliably.

No provision should be recognised because Gustoso Co does not have an obligation to incur the training costs. The expenditure could be avoided by changing the nature of Gustoso Co's operations and so it has no present obligation for the future expenditure.

The provision should be derecognised. This will reduce liabilities by $2 million and increase profits by the same amount.

Restructuring

A provision for restructuring costs should only be recognised in the financial statements of Gustoso Co where all of the above IAS 37 criteria are met. However for a restructuring provision to be recognised there are additional requirements per IAS 37. A constructive obligation for restructuring only arises where a detailed formal plan exists and a valid expectation to those affected by the restructuring that it will take place has occurred. Although the Board meeting happened in November 20X7 Gustoso Co does not yet appear committed as other plans are being explored It is unlikely therefore that the plan is detailed and specific enough for these criteria to be satisfied.

In the case of a restructuring provision, this should only include direct expenditure arising from the restructuring and not associated with ongoing activities. Hence the leasing costs would not be included in a restructuring provision however if a decision is made to exit from these leases, it is likely they could meet the requirements of an onerous lease contract in the 20X8 financial statements. Gustoso Co should therefore look to IFRS 16 Leases and carry out an impairment review of the right-of-use assets held under these lease contracts, applying the requirements of IAS 36 *Impairment of Assets*.

As no announcement has been made to staff or lessors as at the reporting date there is no obligation in existence as at 31 December 20X7 and no provision can be recognised for the other costs - professional fees and redundancy costs. However, the finance director has indicated that a final decision on the restructuring and an announcement is likely to take place before the financial statements are authorised in April 20X8. If this constitutes a material event arising after the reporting date it should be treated as a non-adjusting event. Gustoso Co should disclose the nature of the restructuring and an estimate of its financial effect.

Contract

IFRS 9 *Financial Instruments* applies to contracts to buy or sell a non-financial item which can be settled net in cash. Such contracts are usually accounted for as derivatives. However, contracts which are for an entity's 'own use' of a non-financial asset are exempt from the requirements of IFRS 9. The contract will qualify as 'own use' because Gustoso Co always takes delivery of the wheat. This means that it falls outside the scope of IFRS 9 and so the recognition of a derivative is incorrect.

The contract is an executory contract. Executory contracts are not initially recognised in the financial statements unless they are onerous, in which case a provision is required. This particular contract is unlikely to be onerous because wheat prices may rise again. Moreover, the finished goods which the wheat forms a part of will be sold at a profit. As such, no provision is required. The contract will therefore remain unrecognised until Gustoso Co takes delivery of the wheat.

The derivative liability should be derecognised, meaning that profits will increase by $0.5 million.

Ethical implications

The users of Gustoso Co's financial statements, such as banks and shareholders, trust accountants and rely on them to faithfully represent the effects of a company's transactions. IAS 1 *Presentation of Financial Statements* makes it clear that this will be obtained when accounting standards are correctly applied.

The errors made by Gustoso Co overstate liabilities and understate profits. It is possible that these are unintentional errors. However, incentives exist to depart from particular IFRS and IAS standards: most notably the bonus scheme. The bonus target in 20X7 has been exceeded, and so the finance director may be attempting to shift 'excess' profits into the next year in order to increase the chance of meeting 20X8's bonus target. In this respect, the finance director has a clear self-interest threat to objectivity and may be in breach of ACCA's *Code of Ethics and Conduct*.

The accountant is correct to challenge the finance director and has an ethical responsibility to do so. Despite the fact that the finance director is acting in an intimidating manner, the accountant should explain the technical issues to the director. If the director refuses to comply with accounting standards, then it would be appropriate to discuss the matter with other directors and to seek professional advice from ACCA. Legal advice should be considered if necessary. The accountant should keep a record of conversations and actions. Resignation should be considered if the matters cannot be satisfactorily resolved.

24 Fiskerton

Marking scheme

			Marks
(a)	Application of the following discussion to the scenario:		
	• Correct accounting treatment of the lease	3	
	• Implications for the financial statements	2	
	• Implications for the debt covenant	2	
			7
(b)	Consideration of whether it is performance satisfied over time or at a point in time and application to the scenario	3	
	Conclusion and implications for revenue	1	
			4
(c)	Application of the following discussion of ethical issues to the scenario:		
	• Classification of property as investment property	2	
	• Revaluation and manipulation of the debt covenant	3	
	Consideration of the ethical implications and their resolution	2	
			7
Professional			2
			20

(a) The Halam property should not have been classified as an investment property because it is a finance lease as the lease term is equal to the useful life and its residual value is deemed to be minimal. Edingley should record a right to use asset and Fiskerton should derecognise the property. Fiskerton should instead record a lease receivable equal to the net investment in the lease. The property needs to be removed from investment properties and the fair value gains of $8 million reversed. In any case, the fair value gains were incorrectly calculated since adjustments should have been made for the differences between the Halam building and the one sold due to the different location and quality of the materials between the two buildings. It would appear that $22 million would have been a more accurate reflection of fair value.

The incorrect treatment has enabled Fiskerton to remain within its debt covenant limits. Gearing per the financial extracts is currently around 49.8% (50,000/(10,000 + 20,151 + 70,253)). Fair value gains on investment properties are reported within profit or loss. Retained earnings would consequently be restated to $62.253 million ($70.253m – $8m). Gearing would subsequently become 54.1% (50,000/10,000 + 20,151 + 62,253). Furthermore, retained earnings would be further reduced by correcting for rental receipts.

These presumably have been included in profit or loss rather than deducted from the net investment in the lease. This would in part be offset by interest income which should be recorded in profit or loss at the effective rate of interest. After correcting for these errors, Fiskerton would be in breach of their debt covenants. They have a negative cash balance and would appear unlikely to be able to repay the loan. Serious consideration should therefore be given as to whether Fiskerton is a going concern. It is likely that non-current assets and non-current liabilities should be reclassified to current and recorded at their realisable values. As an absolute minimum, should Fiskerton be able to renegotiate with the bank, the uncertainties surrounding their ability to continue to trade would need to be disclosed.

(b) At the inception of the contract, Fiskerton must determine whether its promise to construct the asset is a performance obligation satisfied over time. Fiskerton only has rights during the production of the asset over the initial deposit paid. It has no enforceable rights to the remaining balance as construction takes place. Therefore, it would not be able to receive payment for work performed to date. Additionally, Fiskerton has to repay the deposit should it fail to complete the construction of the asset in accordance with the contract. There is a single performance obligation which is only met on delivery of the asset to the customer. Revenue should not be recognised on a stage of completion basis but must be deferred and recognised at a point of time. That is, on delivery of the asset to the customer.

(c) It is concerning that the property has been incorrectly classified as an investment property. Accountants have an ethical duty to be professionally competent and act with due care and attention. It is fundamental that the financial statements comply with the accounting standards and principles which underpin them. This may be a genuine mistake but even so would not be one expected from a professionally qualified accountant. The financial statements must comply with the fair presentation principles embedded within IAS 1 *Presentation of Financial Statements.*

The managing director appears to be happy to manipulate the financial statements. A self-interest threat arises from the issue over the debt covenants. It is likely that the managing director is concerned about his job security should the bank recall the debt and deem Fiskerton to no longer be a going concern. It appears highly likely that the revaluation was implemented in the interim financial statements to try to maintain a satisfactory gearing ratio. Even more concerning is that the managing director has deliberately overstated the valuation for the year-end financial statements, even though he is aware that it breaches accounting standards. Such deliberate manipulation is contrary to the ethical principles of integrity, professional behaviour and objectivity. It appears that the managing director is trying to defraud the bank by misrepresenting the liquidity of the business to avoid repayment of the loan. This would be in breach of anti-money laundering regulations.

The sales contract is further evidence that the managing director may be attempting to manipulate the financial statements. The proposed treatment will overstate both revenue and assets which would improve the gearing ratio. A governance issue arises from the behaviour of the managing director. It is important that no one individual is too powerful and domineering in running an entity's affairs. An intimidation threat arises from the managing director pressurising the accountant to overstate revenue from the contract. It was also the managing director who implemented the excessive revaluations on the property. It would appear that the managing director is exercising too much power over the financial statements. The accountant must not be influenced by the behaviour of the managing director and should produce financial statements which are transparent and free from bias. Instead, the managing director should be reminded of their ethical responsibilities. The accountant may need to consider professional advice should the managing director refuse to correct the financial statements.

25 Hudson

Workbook references. Ethics are covered in Chapter 2. Employee benefits and pensions are covered in Chapter 5. Deferred tax is covered in Chapter 7. Restructuring provisions are covered in Chapter 6.

Top tips. Question 2 of the exam will always feature a discussion of ethical issues and will have two marks available for the application of ethical principles. In this question, parts (a) and (b) related to the accounting treatment of the issues in the scenario given, and part (c) required a discussion of the ethical issues arising, including actions that the accountant should take.

In this type of question, remember that ethical issues are likely to be interwoven throughout the scenario - you need to be able to spot them. Remember also that you must apply ethical principles to the scenario. Listing out ethical requirements is unlikely to gain you many marks.

Marking scheme

			Marks
(a)	Application of the following discussion to the scenario:		
	What should be included in the remeasurement component	2	
	Correct treatment of the basic component	2	
	Correct treatment of the additional pension contribution	2	
	Discussion of restructuring costs	2	
			8
(b)	An explanation of temporary differences and asset tax base	3	
	Application of above discussion to the scenario	2	
			5
(c)	Application of the following discussion of accounting issues to the scenario:		
	Termination payments	2	
	Tax losses	1	
	Consideration of the ethical implications and their resolution	2	
			5
	Professional marks		2
			20

(a) The remeasurement component is taken to other comprehensive income and comprises:

- Actuarial gains and losses, such as the return on plan assets which differs from the expected return on the assets included within the net interest figure;
- Changes in the asset ceiling not included within the net interest calculation.

Actuarial gains and losses are sometimes referred to as experience adjustments and arise due to differences between actuarial assumptions and what actually occurred during the period. These will arise in instances such as unexpected movements on interest rates, unexpectedly high or low rates of employee turnover or unexpected increases or decreases in wage growth. The redundancies will create an unusually high level of staff turnover but this should not be treated as part of the remeasurement component. The redundancy will cause the present value of the obligations arising from the defined benefit to decrease. This is classified as a curtailment rather than an experience adjustment to be included within other comprehensive income.

A distinction needs to be made between the basic settlement and the additional pension contribution. The basic settlement is an obligation which Hudson has to pay as compensation for terminating the employee's services regardless of when the employee leaves the entity. IAS 19 Employee Benefits requires such payments to be recognised at the earlier of when the plan of termination is announced and when the entity recognises the associated restructuring costs associated with the closure of Wye.

Hudson should therefore have provided in full for the cost of the basic settlement regardless of whether the staff have left or not. This should be recognised as part of the past service cost in the profit or loss of Hudson for the year ended 31 December 20X2.

The additional pension contribution is only paid to employees who complete service up to the closure of division Wye. Since this is expected in early 20X3, these should be accounted for as a short-term benefit. In effect, the contributions are in exchange for the period of service until redundancy. Hudson should estimate the number of employees who will remain with Hudson until the closure of Wye. The cost of this payment should then be spread over the period of service. Since this should be included within the current service cost, this will have an adverse effect on the profit or loss in both 20X2 and 20X3.

In line with the criteria to recognise any provision, as set out in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, an 'obligating event' must have arisen for a restructuring provision and for the associated restructuring costs to be recognised. Furthermore, specific conditions must exist for such an obligating event to have arisen in relation to a restructuring provision:

- a detailed formal plan for the restructuring is in place identifying certain criteria required by the accounting standard; and
- a valid expectation has been created in those affected that the restructuring will be carried out, either by starting to implement the plan or publicly announcing its main features.

In the case of Hudson, a valid expectation has been created because the restructuring has been announced, the redundancies have been confirmed and the directors have approved the restructuring in a formal directors meeting. IAS 37 specifically sets out that a provision cannot be made where only a management or board decision to restructure has been taken as it is not considered that this in itself gives rise to an obligation to restructure. IAS 37 also specifies that only the direct expenditure which is necessary as a result of restructuring can be included in the restructuring provision. This includes costs of making employees redundant and costs of terminating certain leases and other contracts directly as a result of restructuring. However, it specifically excludes costs of retraining or relocating staff, marketing or investment in new systems and distribution networks, as these costs relate to future operations and so do not fall under the definition of a provision. Thus, the costs of ongoing activities such as relocation activities cannot be provided for.

(b) Deferred taxes represent the amounts of income taxes payable or recoverable in future periods in respect of temporary differences.

Temporary differences are differences between the carrying amount of an asset or liability and its tax base. A deferred tax asset arises where the tax base of an asset exceeds the carrying amount. A deferred tax asset can also occur when the tax base of a liability differs from its carrying amount; the eventual settlement of the liability represents a future tax deduction. In relation to unused trading losses, the carrying amount is zero since the losses have not yet been recognised in the financial statements of Hudson. A potential deferred tax asset does arise but the determination of the tax base is more problematic.

The tax base of an asset is the amount which will be deductible against taxable economic benefits from recovering the carrying amount of the asset. Where recovery of an asset will have no tax consequences, the tax base is equal to the carrying amount.

Hudson operates under a tax jurisdiction which only allows losses to be carried forward for two years. The maximum the tax base could be is therefore equal to the amount of unused losses for 20X1 and 20X2 since these only are available to be deducted from future profits.

The tax base though needs to be restricted to the extent that there is a probability of sufficient future profits to offset the trading losses.

The directors of Hudson should base their forecast of the future profitability on reasonable and supportable assumptions. There appears to be evidence that this is not the case. Hudson has a recent history of trading losses and there is little evidence that there will be an improvement in trading results within the next couple of years. The market is depressed and sales orders for the first quarter of 20X3 are below levels in any of the previous five years. It is also likely that Hudson will incur various costs in relation to the restructuring which would increase losses into 20X3 and possibly 20X4. Only directly attributable expenses such as redundancies should be included within a provision and expensed in 20X2 which would increase the current year loss. On-going expenses may be incurred such as retraining and relocating costs but these should only be expensed from 20X3. The forecast profitability for 20X3 and subsequent growth rate therefore appear to be unrealistically optimistic. Given that losses can only be carried forward for a maximum of two years, it is unlikely that any deferred tax asset should be recognised.

(c) The directors of Hudson are paid a bonus based upon earnings before interest, tax depreciation and amortisation (EBITDA). It is possible therefore, despite the losses, that once these items are adjusted for the directors may receive a bonus. A self-interest threat will arise. The directors have an incentive to manipulate the financial statements in order to try to minimise the losses and maximise profits. Directors have an ethical responsibility to produce financial statements which are fair, objective and a transparent record of the entity's affairs.

There is evidence that the directors are willing to manipulate the financial statements in a way directly contrary to the ethical principles of integrity and objectivity. It is likely that a net expense should be recognised for the termination payments on the assumption that they would exceed the reduction in present value of the obligation from the curtailment. The directors are wishing to recognise this within other comprehensive income rather than profit or loss despite knowing that it is contrary to international accounting standards. This would improve profitability although it would not impact upon net assets due to a corresponding decrease in equity. The directors also have not recognised a restructuring provision despite the terms being communicated to staff. It is possible that this would be treated as an exceptional cost and therefore would not impact on the bonus. It would therefore be useful to examine the precise terms of the contracts in order to assess the potential impact on the bonus. The treatment does, however, at least in the short term, help Hudson to improve their net assets position.

The deferred tax asset is based upon forecasts for too long a period and is also based on unrealistic assumptions. Earnings before interest, tax, depreciation and amortisation will be overstated as a direct consequence. Net assets will also be overstated, helping Hudson to meet its debt covenant obligations.

The directors' explanation for their proposed treatments are not justified. Directors are appointed to run the business on behalf of the company's shareholders who are the primary stakeholder. It will be in the shareholders' interests for the company to be profitable and to maintain net assets within the debt covenant stipulations. However, this should not be at the expense of the credibility and transparency of the financial statements. Deliberate manipulation of financial statements will reduce stakeholders' confidence in the reliability of the financial statements and the accountancy profession as a whole. The directors are deliberating flouting International Financial Reporting Standards (IFRS Standards) to improve their bonus and maintain debt covenant obligations.

The directors' actions with regard to the accountant are contrary to the ethical principles of professional behaviour. It appears that the directors have put the accountant under undue pressure to falsify the financial statements to meet their own needs. An intimidation threat arises from the directors' implying that the accountant would lose their job should they not comply with the directors' instructions.

The accountant would also be bound by the ACCA *Code of Ethics* and must adhere to the same ethical principles. They must not therefore comply with the directors' instructions. The accountant should remind the directors of their obligations to comply with the *Code of Ethics*. Should the accountant feel unable to approach the directors directly, they could consider talking to those charged with governance and, in particular, non-executive directors to explain the situation. The accountant could also seek help from the ACCA ethical helpline and take legal advice. Ultimately, if the situation cannot be resolved, the accountant could consider resigning and seeking employment elsewhere.

26 Stent

Workbook references. Ethics and related party transactions are covered in Chapter 2. Financial instruments are covered in Chapter 8.

Top tips. Question 2 of the exam will always feature a discussion of ethical issues and will have two marks available for the application of ethical principles. In this question, part (a) related to the accounting treatment of the issues in the scenario given as well as the impact on gearing of those accounting treatments. The examiner commented that a surprising number of candidates did not discuss the impact on gearing and therefore missed out on some marks. Make sure you answer each part of a requirement to maximise your score in each question.

Part (b) required a discussion of the ethical issues arising in the scenario. In SBR, ethical issues are likely to go beyond basic accounting errors and could involve personal relationships and pressures that those relationships create - as seen in this question. Be sure to read the question carefully in order to spot these kinds of issues.

Marking scheme

			Marks
(a)	Application of the following discussion to the scenario:		
	Cash advance from related party	4	
	Preference shares: convertible	4	
	Deferred tax asset	3	
			11
(b)	Discussion of ethical principles	2	
	Application of ethical principles to the scenario, and recommended action	5	
			7
	Professional marks		2
			20

(a) **Cash advance from Budster Co**

Stent Co's finance director also controls Budster Co, the company which has paid a cash advance to Stent Co. International Accounting Standard (IAS) 24 *Related Party Disclosures* requires an entity's financial statements to contain disclosures necessary to draw attention to the possibility that its financial statements may have been affected by the existence of related parties and by transactions and outstanding balances with such parties. Included in the definition of a related party is a person identified as holding significant influence over the entity, or who is a member of the key management personnel of the entity. The finance director, a key management personnel of Stent Co, is a related party. In this case, Stent Co must disclose the nature of the related party relationship as well as information about all transactions and outstanding balances between Stent Co and Budster Co (owned and controlled by the finance director), necessary for users to understand the potential effect of the relationship on the financial statements.

The advance from Budster Co meets the *Conceptual Framework* definition of a liability: Stent Co has a present obligation (legally enforceable as a consequence of a binding contract), the settlement of which involves Stent Co giving up resources embodying economic benefits in order to satisfy the claim. IAS 1 *Presentation of Financial Statements* states that an entity shall not offset assets and liabilities, unless required or permitted by an International Financial Reporting Standard (IFRS). The finance director wants to include the receipt as a credit balance in trade receivables, netting off any amounts owed by Budster Co from trading, with what appears to be a short-term loan. This would result in a misclassification of a current liability under current assets. Offsetting a financial asset and a financial liability is permitted according to IAS 32 *Financial Instruments: Presentation* when, and only when, an entity has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. No such agreement is evident in this case, so Stent Co should report separately both assets and liabilities.

Except when it reflects the substance of the transaction or other event, offsetting detracts from the ability of users both to understand the transactions, other events and conditions which have occurred and to assess the entity's future cash flows. Stent Co would be showing a lower current asset figure and concealing the liability, which if disclosed as a current liability could be included in the debt element of the gearing calculation. Gearing would therefore increase.

Convertible redeemable preference shares

IAS 32 defines an equity instrument as any contract which evidences a residual interest in the assets of an entity after deducting all of its liabilities. An equity instrument has no contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities under potentially unfavourable conditions. If settled by the issuer's own equity instruments, an equity instrument has no contractual obligation to deliver a variable number, or is settled only by exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

Preference shares which are required to be converted into a fixed number of ordinary shares on a fixed date should be classified as equity (this is known as the 'fixed for fixed' requirement to which the finance director refers). However, a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer either to deliver cash or another financial asset to the holder, or to exchange financial assets or financial liabilities with the holder, under conditions which are potentially unfavourable to the issuer. In this case, Stent Co has issued convertible redeemable preference shares – which makes little commercial sense from the company's perspective, as they offer the holder the benefit of conversion into ordinary shares if share prices rise, and the security of redemption (at the choice of the holder) if share prices fall.

IAS 32 notes that the substance of a financial instrument, rather than its legal form, governs its classification in the entity's statement of financial position. A preference share which provides for mandatory redemption for a fixed or determinable amount at a fixed or determinable future date or gives the holder the right to require the issuer to redeem the instrument at a particular date for a fixed or determinable amount is a financial liability.

Because the preference shares offer the holder the choice of conversion into ordinary shares as well as redemption in two years' time, the terms of the financial instrument should be evaluated to determine whether it contains both a liability and an equity component. Such components are classified separately as compound financial instruments, recognising separately the components of a financial instrument which creates both a financial liability of the entity (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity).

In accordance with IFRS 9 *Financial Instruments*, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. Stent Co would measure the fair value of the consideration in respect of the liability component based on the fair value of a similar liability without any associated equity conversion option. The equity component is assigned the residual amount.

Gearing would increase if the draft financial statements had included the preference shares within equity: the correction would increase non-current debt (the present value of the future obligations) and decrease equity.

Deferred tax asset

In accordance with IAS 12 *Income Taxes*, a deferred tax asset shall be recognised for the carry-forward of unused tax losses to the extent that it is probable that future taxable profit will be available against which the unused tax losses can be utilised.

However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses only to the extent that it has convincing evidence that sufficient taxable profit will be available against which the unused tax losses can be utilised. In such circumstances, the amount of the deferred tax asset and the nature of the evidence supporting its recognition must be disclosed. The directors of Stent Co should consider whether it is probable that Stent Co will have taxable profits before the unused tax losses or unused tax credits expire, whether the unused tax losses result from identifiable causes which are unlikely to recur; and whether tax planning opportunities are available to the entity which will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised. To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset should not be recognised.

The removal of a deferred tax asset would reduce net assets, and equity. Gearing would therefore increase.

(b) **Ethical aspects**

The ACCA Rulebook contains the byelaws, regulations and *Code of Ethics and Conduct*, which every ACCA member should follow. The accountant may feel pressured by the finance director's comments on job security given the accountant has only been in her position for a few months. The accountant should comply with the fundamental ethical principles set out in the ACCA Rulebook: to act with integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. The accountant should be mindful of any threats to these fundamental ethical principles. In doing so, the accountant should consider the relevant facts, the ethical issues involved, the fundamental principles which are threatened, whether internal procedures exist which mitigate the threats, and what alternative courses of action could be taken.

In this case, all fundamental ethical principles with the exception of confidentiality appear under threat. The finance director appears to be allowing bias and undue influence from the pressures imposed by debt covenant gearing and overdraft limits into the choice of accounting treatment, rather than following accounting standards. The company is in a precarious position, reporting losses in the year. The finance director should act professionally, in accordance with applicable technical and professional standards, comply with relevant laws and regulations, and avoid any action which discredits the profession.

The finance director faces an advocacy threat by promoting accounting treatments which compromise objectivity. The accountant faces an intimidation threat given the comments from the finance director, who presumably has an influence over career prospects. Assuming the accountant wishes to keep her job, this intimidation threat is also linked to one of self-interest. Before acting, the accountant should speak with the finance director, try to confirm the facts, and discuss the treatment with the finance director and explain the risks of non-compliance: the safeguards of accounting regulations and the sanctions imposed on those professional accountants who do not comply may resolve the issue. A record of conversations and actions should be kept. Stent Co may also have internal procedures which mitigate the threats. It may be that the finance director is not technically up to date, in which case a safeguard would be to undergo continuing professional development. If the finance director refuses to comply with accounting standards, then it would be appropriate to discuss the matter with other directors or an audit committee (if applicable), to seek a solution, then seek professional advice from ACCA, and consider legal advice if necessary. A final consideration for the accountant, if matters cannot be satisfactorily resolved, would be resignation.

27 Calendar Co

Marking scheme

			Marks
(a)	Discussion of the principles of relevant standards (IFRS 15, IAS 38, IAS 8)	3	
	Application of the principles to Calendar Co	3	
			6
(b)	Discussion of IFRS 16 principles of right of control	4	
	Application of right of control principles to Calendar Co	5	
			9
(c)	Discussion of principles of materiality and reference to Practice Statement 2	4	
	Application of principles to PPE purchases by Calendar Co	3	
	Application of principles to disclosure checklist use by Calendar Co	3	
			10
			25

(a) **Sale of intangible**

IFRS 15 *Revenue from Contracts with Customers* defines revenue as income arising from an entity's ordinary activities. Calendar Co's ordinary activities do not involve selling development projects. In fact, Calendar Co has made no such sales since 20X0. It would seem that Calendar Co's business model instead involves developing products for its customers, who then take over its production, marketing and sale. Stage payments and royalties are the incomes which arise from Calendar Co's ordinary activities and should be treated as revenue.

Based on the above, Calendar Co is incorrect to recognise the gain as revenue. In fact, IAS 38 *Intangible Assets* explicitly prohibits the classification of a gain on derecognition of an intangible asset as revenue.

IAS 38 defines an intangible asset as an identifiable non-monetary asset without physical substance. Intangible assets held for sale in the ordinary course of business are outside the scope of IAS 38 and are instead accounted for in accordance with IAS 2 *Inventories*. The fact that the development project was classified as an intangible asset upon initial recognition further suggests that it was not held for sale in the ordinary course of business.

If the development was incorrectly categorised in the prior year financial statements as an intangible asset, then, as per IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, this should be corrected retrospectively. However, based on the infrequency of such sales, it seems unlikely that the development was misclassified.

(b) **Contract**

IFRS 16 *Leases* says that a contract contains a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. When deciding if a contract involves the right to control an asset, the customer must assess whether they have:

- The right to substantially all of the identified asset's economic benefits;
- The right to direct the asset's use.

Calendar Co has the right to use a specified aircraft for three years in exchange for annual payments. Although Diary Co can substitute the aircraft for an alternative, the costs of doing so would be prohibitive because of the strict specifications outlined in the contract.

Calendar Co appears to have control over the aircraft during the three-year period because no other parties can use the aircraft during this time, and Calendar Co makes key decisions about the aircraft's destinations and the cargo and passengers which it transports. There are some contractual restrictions which limit the aircraft's use. These restrictions define the scope of Calendar Co's right of use but do not prevent it from having the right to direct the use of the aircraft.

Based on the above, the contract contains a lease. IFRS 16 permits exemptions for leases of less than 12 months or leases of low value. However, this lease contract is for three years, so is not short term, and is for a high value asset so a lease liability should have been recognised at contract inception. The lease liability should equal the present value of the payments yet to be made, using the discount rate implicit in the lease or, where unavailable, the lessee's incremental borrowing rate. A finance cost accrues over the year, which is charged to profit or loss and added to the carrying amount of the lease liability. The year-end cash payment should be removed from profit or loss and deducted from the carrying amount of the liability.

A right-of-use asset should have been recognised at the contract commencement at an amount equal to the initial value of the lease liability plus the initial costs to Calendar Co of negotiating the lease. The right-of-use asset should be depreciated over the lease term of three years and so one year's depreciation should be charged to profit or loss.

(c) **Materiality**

Calendar Co's financial statements should help investors, lenders and other creditors to make economic decisions about providing it with resources. An item is material if omitting, misstating or obscuring it might influence the economic decisions of the users of the financial statements. Materiality is not a purely quantitative consideration; an item can be material if it triggers non-compliance with laws and regulations, or bank covenants. Calendar Co should consider materiality throughout the process of preparing its financial statements to ensure that relevant information is not omitted, misstated or obscured.

Property, plant and equipment (PPE)

IAS 16 Property, Plant and Equipment states that expenditure on PPE should be recognised as an asset and initially measured at the cost of purchase. Writing off such expenditure to profit or loss is therefore not in accordance with IAS 16.

According to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, financial statements do not comply with IFRS Standards if they contain material errors, or errors made intentionally in order to present the entity's financial performance and position in a particular way. However, assuming that the aggregate impact of writing off small PPE purchases to profit or loss is not material, then the financial statements would still comply with IFRS Standards. Moreover, this decision seems to be a practical expedient which will reduce the time and cost involved in producing financial statements, rather than a decision made to achieve a particular financial statement presentation.

If implemented, this policy must be regularly reassessed to ensure that PPE and the statement of profit or loss are not materially misstated.

Disclosure notes

IAS 1 *Presentation of Financial Statements* states that application of IFRS Standards in an entity's financial statements will result in a fair presentation. As such, the use of a checklist may help to ensure that all disclosure requirements within IFRS Standards are fulfilled. However, IAS 1 and IFRS Practice Statement 2 *Making Materiality Judgements* both specify that the disclosures required by IFRS Standards are only required if the information presented is material.

The aim of disclosure notes is to further explain items included in the primary financial statements as well as unrecognised items (such as contingent liabilities) and other events which might influence the decisions of financial statement users (such as events after the reporting period). As such, Calendar Co should exercise judgement about the disclosures which it prepares, taking into account the information needs of its specific stakeholders. This is because the disclosure of immaterial information clutters the financial statements and makes relevant information harder to find.

Calendar Co may also need to disclose information in addition to that specified in IFRS Standards if relevant to helping users understand its financial statements.

28 Digiwire

Workbook references. IFRS 15 on revenue is covered in Chapter 3. IFRS 13 *Fair Value Measurement* is covered in Chapter 4 and IFRS 9 *Financial Instruments* is covered in chapter 8.

Top tips. This question is set in the context of a digital business, something that the examiner has highlighted could be a feature of questions in SBR. The company in the question, Digiwire, sold music licences to other companies who then provide digital music to customers.

Part (a) concerned revenue recognition. In part (a)(ii), you were asked to show how the accounting treatment was supported by the *Conceptual Framework*. The principles in the *Conceptual Framework* are crucial to SBR and are likely to feature in every exam in some way. Therefore, you need to make sure you know the principles in the *Conceptual Framework* and be able to show how those principles support accounting standards, or in some cases, are at odds with accounting standards.

Part (b) included a discussion of whether cryptocurrency can be classified as a financial asset or intangible asset. The examiner report expressed surprise that answers to this question were generally weak given that there is a technical article on Cryptocurrency available on the ACCA website. This highlights the importance of reading the technical articles available - see the exam resources section of the ACCA website.

Part (c) considers debt factoring under IFRS 9. Remember that the substance of the arrangement must be considered.

Marking scheme

				Marks
(a)	(i)	Application of the following discussion to the scenario:		
		• IFRS 15 non-cash consideration and IFRS 13 alternatives to value the shares (including share value calculation at year end)	3	
		• IFRS 9 remeasurement gains (including calculation)	2	
	(ii)	Application of the following discussion to the scenario:		
		• Revenue recognised over time	2	
		• *Conceptual Framework*	2	
				9

				Marks
(b)	(i)	Discussion and application of the IFRS 11 requirements to the scenario	2	
	(ii)	Discussion of the derecognition of non-monetary assets and application to the scenario	2	
		Calculation of carrying amount of the joint venture	1	
	(iii)	Discussion of the potential ways in which the cryptocurrency could be accounted for at fair value	4	
				9
(c)	IFRS 9 requirements		1	
	Agreement 1		4	
	Agreement 2		2	
				7
				25

(a) (i) **Revenue recognition: Clamusic Co shares**

IFRS 15 *Revenue from Contracts with Customers* requires that non-cash consideration received should be measured at the fair value of the consideration received. If fair value cannot be reasonably estimated, the consideration should be measured by reference to the stand-alone selling price of the good or service promised in the contract. The fair value of non-cash consideration may vary. If the non-cash consideration varies for reasons other than the form of the consideration, entities will apply the guidance in IFRS 15 related to constraining variable consideration. However, if fair value varies only due to the form, the variable constraint guidance in IFRS 15 would not apply. In this case, the fair value varies due to the form of the consideration which is equity shares and therefore the variable constraint guidance in IFRS 15 does not apply.

The fair valuation of shares in an unlisted start-up company is problematic. However, IFRS 13 *Fair Value Measurement* gives advice on how to measure unlisted shares. It sets out three approaches: (i) market approach, such as the transaction price paid for identical or similar instruments of an investee; (ii) the income approach, for example, using discounted cash flow; and (iii) the adjusted net asset approach.

In this case, the market approach has been used and the range of fair values is significant based upon the professional valuation report. The range of fair values for a 7% holding of shares would be $280,000 to $350,000 (7% of $4–$5 million) at the date of the contract and $420,000 to $490,000 (7% of $6–$7 million) at the year end. As the fair valuation is based upon a similar listed company and is based upon a controlling interest, a discount on the valuation of the shares should be applied to reflect the lack of liquidity and inability to participate in Digiwire Co's policy decisions. Thus, an estimated value of the shares can be made which takes into account the above facts. This could be the mid-point of $315,000 (($280,000 + $350,000)/2) at the date of the contract and $455,000 (($420,000 + $490,000)/2) at the year end. Digiwire Co would therefore recognise revenue of $315,000 for the receipt of shares from Clamusic Co, as the fair value of non-cash consideration is measured at the contract inception date of 1 January 20X6. This revenue would not be recognised at a point in time but would be recognised over the period of the licence which is three years.

Clamusic Co share valuation at 31 December 20X6

The shares will be recognised at $455,000 (($420,000 + $490,000)/2) at 31 December 20X6. All equity investments in scope of IFRS 9 *Financial Instruments* should be measured at fair value in the statement of financial position, with value changes being recognised in profit or loss. If an equity investment is not held for trading, an entity can make an irrevocable election at initial recognition to measure it at fair value through other comprehensive income (FVTOCI) with only dividend income recognised in profit or loss.

If Digiwire Co elects to present the remeasurements through other comprehensive income (OCI), gains are never recycled through profit or loss. This means that, if the investment in Clamusic Co is successful, when the investment is sold, there will be no profit or loss effect since all gains will already have been recognised in OCI. Thus at the year end, a gain of $140,000 ($455,000 – $315,000) will be recorded in profit or loss or OCI dependent upon any election being made.

(ii) **Revenue: royalties**

As Digiwire Co retains an active role in the updating and maintenance of a sold licence to ensure its continuing value to the client, revenue would be recognised over the expected length of the contract or related client relationship. An entity must be expected to undertake activities which significantly affect the licence to conclude that revenue is recognised over time. However, reliable measurement of future royalties is not available (see below). Thus, in this case, the revenue would be recognised over the three-year licence based upon the licence agreement. At the year end, however, revenue from royalties can be calculated based upon the sales for the period and it would be $50,000 (5% of $1 million).

The *Conceptual Framework* support

The International Accounting Standards Board has changed the definitions of income and expenses in the *Conceptual Framework* to align with the revised definitions of an asset and a liability. The definition of income encompasses increases in assets or decreases in liabilities which result in increases in equity, other than those relating to contributions from holders of equity claims.

The *Conceptual Framework* also states that an item which meets the definition of an element should only be recognised if it provides users of financial statements with information which is useful. The *Conceptual Framework* defines useful information as: (a) relevant information; and (b) a faithful representation. Relevance may not always be achieved if there is uncertainty over existence or the probability of an inflow of economic benefits is low. Faithful representation will be affected by measurement uncertainty.

Thus, in this case, the royalties cannot be measured with any certainty in the future and should not be recognised until certain. The definitions in the *Conceptual Framework* relating to revenue, recognition and gains are therefore consistent with the approach taken by Digiwire Co.

(b) (i) It seems that Digiwire Co and TechGame jointly control FourDee Co and it appears as though the arrangement is a joint venture (IFRS 11 *Joint Arrangements*) as the parties have joint control of the arrangement and have rights to the net assets of the arrangement. Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. This is the case with FourDee Co.

A joint venturer recognises its interest in a joint venture as an investment and accounts for that investment using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures* unless the entity is exempted.

(ii) Digiwire Co has exchanged non-monetary assets for its investment in FourDee Co, and thus needs to de-recognise the assets it is contributing to FourDee Co. The carrying amount of $6 million of the property is derecognised but the intellectual property of Digiwire Co has been generated internally and does not have a carrying amount. The cryptocurrency is recorded as an asset in the financial statements of Digiwire Co at $3 million but will be valued at $4 million, its fair value in the financial statements of FourDee Co.

Accordingly, when a joint venturer contributes a non-monetary asset to a joint venture in exchange for an equity interest in the joint venture, the joint venturer recognises a portion of the gain or loss on disposal which is attributable to the other parties to the joint venture (except when the contribution lacks commercial substance). Essentially, Digiwire Co is required by IAS 28 to limit the profit on disposal of its non-monetary assets to 50%. Effectively, Digiwire Co has only disposed of 50% of the asset contributed to the joint venture. Thus, the carrying amount of the joint venture in Digwire Co's financial statements at 31 December 20X6 will be $11.5 million (($6 + $3 carrying amounts derecognised for property and cryptocurrency) + ((4 – 3)/2) + ((10 – 6)/2)). A gain of $2.5 million will be recorded in profit or loss.

(iii) If the cryptocurrency meets the definition of a financial asset, it is possible to measure it at fair value. However, cryptocurrency is not cash or cash equivalents as its value is exposed to significant changes in market value and there is no contractual right to receive either cash or cash equivalents. Therefore, cryptocurrency fails the definition of a financial asset.

If the cryptocurrency is to be recognised as an intangible asset, then the default position would be to measure it at cost. However, there may be an argument to say that there is an active market for the cryptocurrency in which case, it would be possible for it to be measured at fair value. In this case, movements in that fair value would be recognised through other comprehensive income and the gain would not be recycled through profit or loss when the cryptocurrency is realised.

The best way to account for a cryptocurrency would be fair value as that is the value at which the entity will realise their investment or transact in exchange for goods and services. Accounting for cryptocurrency at fair value with movements reflected in profit or loss would provide the most useful information to investors but existing accounting requirements do not appear to permit this.

(c) **Debt factoring**

IFRS 9 *Financial Instruments* requires Digiwire Co to consider the commercial substance rather than the legal form of the debt factoring arrangements. Under IFRS 9, the trade receivables should be derecognised from the financial statements of Digiwire Co when the following conditions are met:

(i) When Digiwire Co has no further rights to receive cash from the factor; and either

(ii) When substantially all of the risks and rewards of ownership relating to the receivables have been transferred to the factor, or if substantially all of the risks and rewards have not been transferred, then

(iii) When Digiwire Co has no further control over the trade receivables

Agreement one

With agreement one, there is a sharing of the risks and rewards of ownership as the factoring is non-recourse except that Digiwire Co retains an obligation to refund the factor 9% of any unrecovered debts. It can be seen, however, that substantially all the risks and rewards of ownership have passed to the factor. The probability of an individual default is low given that there is low credit risk and the factor would suffer the vast majority of the loss arising from any default. Digiwire Co also has no further access to the rewards of ownership as the initial $32 million (80% × $40 million) is in full and final settlement. Furthermore, the factor has assumed full control over the collectability of the receivables. The trade receivables should be derecognised from the financial statements of Digiwire Co and $8 million, being the difference between the amount of the receivables sold and the cash received, should be charged as an irrecoverable debt expense against the profits of Digiwire Co.

The guarantee should be treated as a separate financial liability in accordance with IFRS 9. This would initially be measured at its fair value of $50,000.

Agreement two

The risks and rewards of ownership do not initially pass to the factor in relation to agreement two. The factor has full recourse to Digiwire Co for a six-month period so the irrecoverable debt risk is still with Digiwire Co. Furthermore, Digiwire Co still has the right to receive further cash payments from the factor, the amounts to be received being dependent on when and if the customers pay the factor. Digiwire Co therefore still has the risks associated with slow or non-payment by their customers. The receivables must continue to be recognised in the financial statements with the $0.8 million (20% × $4m) proceeds being treated as a short-term liability due to the factor. The receivables and liability balances would gradually be reduced as the factor recovered the cash from Digiwire Co's receivables which would be adjusted for the imputed interest and expensed in profit or loss.

Following six months the risks and rewards of ownership have passed to the factor and the balances on the loan and the receivables would be offset. The remaining balance following offset within the receivables of Digiwire Co should be expensed in profit or loss as an irrecoverable debt.

29 Ecoma Co

Workbook references. Sustainability reporting is covered in Chapter 18. Provisions are covered in Chapter 6. Pensions are covered in Chapter 5. Leases are covered in Chapter 8.

Top tips. Part (a) required discussion on the disclosure of sustainability and environment, social and governance (ESG) issues and its importance to investors. The examiner's report pointed out that reading the ACCA article on the sustainable development goals (available in the study support resources section of the ACCA website) would have provided good background information for this question. Part (b) looked at the accounting treatment of management responses to sustainability issues. Part (b)(i) included a lease that was onerous. The ACCA suggested solution given below discusses the accounting treatment of this lease as an onerous contract under IAS 37.

However, this accounting treatment only arises on initial application of IFRS 16. This treatment is covered in an ACCA article 'Onerous lease contracts and impairments, and investor issues' (available in the study support resources section of the ACCA website). It is unlikely that you would have been aware of this specific point, but, as with all questions in the SBR exam, marks would have been awarded for sensible discussion of the issues, applying appropriate principles, even if that is different to the suggested solution. The usual treatment of an onerous lease, once IFRS 16 has been applied, is to test the right-of-use asset for impairment under IAS 36 and marks would have been awarded for a discussion of this treatment.

Marking scheme

				Marks
(a)	Discussion of why it is important to investors that companies disclose sustainable information			
		Relevance	2	
		Opportunities	1	
		Valuation models	2	
		Risks	2	
		Screening strategies	1	
				8
(b)	(i)	Discussion and application of the following to the scenario:		
		IAS 37 onerous contract	3	
		Future losses	1	
		Provision	2	
				6
	(ii)	Discussion and application to scenario of the principles and practice of accounting for the pension scheme	4	
		Calculation of net pension obligation	3	
				7
	(iii)	Calculation of the general impact on earnings		2
Professional marks				2
				25

(a) There is increasing interest by investors in understanding how businesses are developing environmental, social or governance (ESG) goals. The positioning of the ESGs in relation to the overall corporate strategies is information which investors feel is very relevant to the investment decision which in turn will lead to capital being channelled to responsible businesses.

Sustainability practices will not all be equally relevant to all companies and investors' expectations are likely to focus on companies realising their core business activities with financial sustainability as a prerequisite for attracting investment. Because institutional investors have a fiduciary duty to act in the best interests of their beneficiaries, such institutions have to take into account sustainability practices. Companies utilising more sustainable business practices provide new investment opportunities. Investors realise that environmental events can create costs for their portfolio in the form of insurance premiums, taxes and the physical cost related with disasters. Social issues can lead to unrest and instability, which carries business risks which may reduce future cash flows and financial returns.

Investors screen the sustainable policies of companies and factor the information into their valuation models. Investors may select a company for investment based on specific policy criteria such as education and health. Investors may evaluate how successful a company has been in a particular area, for example, the reduction of educational inequality. This approach can help optimise financial returns and demonstrate their contribution to sustainability. Investors increasingly promote sustainable economies and markets to improve their long-term financial performance. However, the disclosure of information should be in line with widely accepted recommendations such as the Global Reporting Initiative (GRI) and the UN Global Compact. Integrated reporting incorporates appropriate material sustainability information equally alongside financial information, thus providing reporting organisations with a broad perspective on risk.

Investors often require an understanding of how the directors feel about the relevance of sustainability to the overall corporate strategy, and this will include a discussion of any risks and opportunities identified and changes which have occurred in the business model as a result.

Investors employ screening strategies, which may involve eliminating companies which have a specific feature, for example, low pay rates or eliminating them on a ranking basis. The latter may be on the basis of companies which are contributing or not to sustainability. Investors will use related disclosures to identify risks and opportunities on which they wish to engage with companies. Investors will see potential business opportunities in those companies which address the risks to people and the environment and those companies which develop new beneficial products, services and investments which mitigate the business risks related to sustainability. Investors are increasingly seeking investment opportunities which can make a credible contribution to the realisation of the ESGs.

(b) (i) Ecoma Co cannot make a provision of $16 million as the company cannot make a provision for the future operating losses of $20 million (these are specifically not allowed by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*), nor take account of the saving of $2 million per annum as no obligation exists. However, the lease represents an onerous contract and an appropriate provision should be made. IAS 37 defines an onerous contract as 'a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.' There are no explicit requirements for entities to 'search' for onerous contracts but it is implicit in the onerous contract principles that reasonable steps should be taken to identify them. If an onerous contract is identified, a provision must be recognised for the best suitable estimate of the unavoidable cost. IAS 37 defines the unavoidable costs under a contract as the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation and penalties arising from failure to fulfil it. Before a separate provision for an onerous contract is recognised, an entity recognises any impairment loss which has occurred on assets dedicated to that contract.

The onerous contract should be measured by determining the present value of the unavoidable costs, net of the expected benefits under the contract. The discount rate should be a pre-tax rate which reflects current market assessments of the time value of money and the risks specific to the liability.

In this case, the requirements of the onerous contract must be considered along with the prohibition in IAS 37 of providing for future operating losses. It is important to distinguish between unavoidable costs under an onerous contract, and future operating losses. Future operating losses are not independent of the entity's future actions and do not normally stem from an obligation arising from a past event. A provision for onerous contracts is recognised if the unavoidable costs of meeting the obligations under the contract, or exiting from it, exceed the economic benefits expected to be received under it.

Therefore, the unavoidable cost of the onerous contract should be discounted to 30 September 20X5 is ($600,000 + $600,000/1.05), ie $1,171,429.

The expected benefit of sub-letting the building arising at 30 September 20X5 will be ($400,000 + (40% × 400,000)/1.05), ie $552,381.

A provision of $(1,171,429 – 552,381) $1,619,048 can therefore be made. In addition, a provision of $1 million can be made for the costs of moving to the new head office if it is felt that the cost is unavoidable. This gives a total provision of $1,619,048.

Tutorial note:

IFRS 16 *Leases* says that the right-of-use asset at the date of initial application is adjusted by the amount of any provision for onerous leases recognised in the statement of financial position.

(ii) At each financial year end, the plan assets and the defined benefit obligation are remeasured. Remeasurement gains and losses are recognised in other comprehensive income.

The statement of profit or loss records the change in the surplus or deficit except for contributions to the plan and benefits paid by the plan and remeasurement gains and losses.

The amount of pension expense to be recognised in profit or loss is comprised of service costs and net interest costs. Service costs are the current service costs, which is the increase in the present value of the defined benefit obligation resulting from employee services in the current period, and 'past-service costs'. Ecoma Co's past-service costs are the changes in the present value of the defined benefit obligation for employee services in prior periods which have resulted from the plan amendment and should be recognised as an expense. IAS 19 *Employee Benefits* requires all past service costs to be recognised as an expense at the earlier of the following dates:

(a) When the plan amendment or curtailment occurs, and
(b) When the entity recognises related restructuring costs or termination benefits.

These costs should be recognised regardless of vesting requirements. Thus, the past service cost of $9 million will be recognised at 30 September 20X5.

Net interest on the net defined benefit liability is calculated by multiplying the opening net defined benefit liability by the discount rate at the start of the annual reporting period. Net interest on the net defined benefit liability can be viewed as effectively including theoretical interest income on plan assets.

The table below reflects the change in the net pension obligation for the period. The profit or loss will be charged with the net interest component of $3.2 million and the service cost of $27 million ($18 million + $9 million). OCI will be credited with $1.2 million and this gain cannot be reclassified to profit or loss. Benefits paid have no effect on the net obligation as both plan assets and obligations are reduced by $6 million.

	$m	Charge to
Net pension obligation at 30 September 20X4	59	
Net interest component (5.5% × 59m)	3.2	Profit or loss
Service cost for year	18	Profit or loss
Past service cost relating to plan amendment at 30 September 20X5	9	Profit or loss
Contributions	(10)	Already credited to cash
Remeasurement	(1.2)	To OCI
Net pension obligation at 30 September 20X5	78	

(iii) Thus profit before tax of $25 million will suffer as the profit available to the ordinary shareholders will be reduced by:

	$m
Onerous contract provision (part (i))	1.6
Net interest component	3.2
Past and current service cost	27
	31.8

Thus, a loss of $6.8 million ($25 million – $31.8 million) will now be reported.

30 Egin Group

Workbook reference. Materiality and IFRS Practice Statement 2 are covered in chapter 20. Integrated Reporting is covered in Chapter 18. Related parties are covered in Chapter 2.

Top tips. This question dealt with materiality as a current issue in part (a). The definition of materiality in part (a)(i) is straightforward, but the consideration of how it could lead to a reduction in clarity and understandability needs more thought. Credit will be given for valid arguments. Integrated reporting has been tested in a number of contexts, here in the context of materiality. You needed to consider how materiality is relevant to the objective of the International Integrated Reporting Framework. The best way to approach Part (b) is to prepare a plan on your exam by adding to the group structure provided any entities or individuals who are not shown as well as any transactions between the entities and individuals involved. Then you need to apply the IAS 24 related party definitions.

Easy marks. The definition of materiality (part (a)(i)) was a good way to earn easy marks. You could also pick up some easy marks in part (a)(i) by having a working knowledge of IFRS Practice Statement 2.

Marking scheme

				Marks
(a)	(i)	Materiality and IFRS Practice Statement 2: 1 mark per well-explained point up to 6 marks	6	
	(ii)	Materiality and integrated reporting: 1 mark per well-explained point up to 4 marks	4	
				10
(b)	(i)	Reasons	4	
		Materiality	2	
				6
	(ii)	Egin Group	5	
		Spade	3	
		Atomic	1	
				9
				25

BPP LEARNING MEDIA

(a) (i) *Definition of materiality and application of the concept*

Information is **material** if **omitting, misstating or obscuring it** could reasonably be expected to **influence decisions** that primary users make on the basis of financial information about a specific reporting entity.

Materiality is an **entity-specific** aspect of relevance, based on the **nature and/or magnitude** of the items to which it relates in the context of the entity's financial report.

It is therefore **difficult to specify a uniform quantitative threshold** for materiality or predetermine what could be material in a particular situation.

Materiality should ensure that **relevant information is not omitted or mis-stated.** In 2018, the IASB amended the definition of materiality to clarify that relevant information **should not be obscured** by information which is not useful to primary users of financial statements, addressing the issue that too much information can be just as problematic as the omission of information.

The *Conceptual Framework* describes materiality as an **application** by a particular **entity** of the fundamental **qualitative characteristic of relevance**. When an entity is assessing materiality, it is assessing whether the information is relevant to the primary users of its own financial statements. Information relevant for one entity might not be as relevant for another entity.

Although **preparers** may understand the concept of materiality, they may be **less certain about how it should be applied**. Preparers may be **reluctant to filter** out **information which is not relevant** to users as **auditors and regulators may challenge** their reasons for the omissions, particularly where the disclosure is required by an IFRS Standard.

IFRS Practice Statement 2: Making Materiality Judgements

IFRS Practice Statement 2 is **non-mandatory guidance.**

The guidance confirms the general requirement in IAS 1 that an entity need not provide information which is not material:

- The recognition and measurement criteria in an IFRS Standard only need to be applied when **the effect** of applying them is **material**.
- An entity **does not need to make a certain disclosure**, even if that disclosure is part of a list of 'minimum required disclosures' in an IFRS Standard if the information provided by that disclosure requirement is **not material**.

The guidance includes a suggested 4-step process to making materiality judgements which includes identifying potentially material information and assessing whether that information is material.

To assess whether the information is material, preparers should assess whether the information could reasonably be expected to influence primary users. This requires the consideration of both **quantitative** and **qualitative factors**.

Quantitative factors consider the size of the effect of the transaction. These can be assessed with the help of a threshold – eg 5% of profit.

Qualitative factors are characteristics that make information more likely to influence the decisions of primary users, they can be internal or external.

It is usually **more efficient** to assess items from a **quantitative perspective first**: if an item exceeds the quantitative threshold, it is material and no further assessment is required.

As the final part of the 4-step process, the entity should review a complete set of draft financial statements, considering whether all material information has been identified and whether materiality has been considered from a wide perspective and in aggregate.

(ii) **Materiality and the International Integrated Reporting Framework**

Integrated reporting takes a broader view of business reporting, emphasising the need for entities to provide information to help investors assess the current shape and performance of the business, the likely effect of management's plans, external issues and opportunities, and the long-term value of a business. Integrated reporting is a process which results in communication, through the integrated report, about how a business creates value over time.

An integrated report is a concise communication about how an organisation's strategy, governance, performance and prospects lead to the creation of value over the short, medium and long term.

Materiality is a guiding principle in the International Integrated Reporting Framework. In the Framework, a matter is considered material if it could substantively affect the organisation's ability to create value over time.

For financial reporting purposes, the nature or extent of an omission or misstatement in the organisation's financial statements determines relevance. Matters which are considered material for financial reporting purposes, or for other forms of reporting, may also be material for integrated reporting purposes if they are of such relevance and importance that they could change the assessments of providers of financial capital with regard to the organisation's ability to create value. Another feature of materiality for integrated reporting purposes is that the definition emphasises the involvement of senior management and those charged with governance in the materiality determination process in order for the organisation to determine how best to disclose its value creation development in a meaningful and transparent way.

(b) (i) **Why it is important to disclose related party transactions**

The directors of Egin are correct to say that related party transactions are a normal feature of business. However, where entities are members of the same group, for example parent and subsidiary, the **financial performance and position of both entities can be affected** by these transactions. An obvious instance of this is where one group company sells goods to another at artificially low prices which can have a detrimental impact on the stakeholders of the selling company.

In the absence of other information, users of the financial statements **assume that a company pursues its interests independently** and undertakes transactions on an **arm's length basis** on terms that could have been obtained in a transaction with a third party.

Knowledge of related party relationships and transactions affects the way in which users assess a company's operations and the risks and opportunities that it faces. Therefore, **details of an entity's controlling party and transactions with related parties should be disclosed.**

It is essential to the **stakeholders' positive view of a company's moral and ethical behaviour** that **controls** are in place to **capture related party disclosures** that are accurate and complete. This serves to **minimise the risk of unethical** or fraudulent **behaviour**.

Materiality judgement

Disclosure of related party transactions, like all other disclosure in financial statements, is subject to the over-arching characteristic of materiality, as is confirmed by IFRS Practice Statement 2: *Making Materiality Judgements*.

The size, nature and context of the related party transaction should be taken into account. A transaction may be small, such that it would be immaterial if it were not with a related party. However, the fact that it is with a related party, which is a qualitative factor, lowers the quantitative threshold for determining if it is material. Ultimately, the entity needs to determine whether disclosing the information could reasonably be expected to influence primary users' decisions. If not, then it is not material and disclosure of that information is not required.

(ii) **Nature of related party relationships**

Within the Egin Group

Briars and Doye are related parties of Egin because they are **members of the same group** (both subsidiaries of Egin). For the same reason, as fellow subsidiaries, **Briars and Doye** are also **related parties of each other. Eye is also a related party of Egin** because it is an **associate of Egin**. (Egin has **significant influence** over Eye.)

Briars and Doye are also related parties of Eye. There is only one director in common and IAS 24 states that entities are not necessarily related simply because they have a director (or other member of key management personnel) in common, or because a member of key management personnel of one entity has significant influence over the other entity. However, as **Eye is a member of the same group** that Briars and Doye are members of, they are related.

Although Tang was sold several months before the year end it was a **related party** of the Egin Group until then. Therefore, the related party relationship between Tang and the Egin Group **should be disclosed** even though there were no transactions between them during the period.

Blue is a related party of Briars as a **director of Briars controls it.** Because the director is not on the management board of Egin it is **not clear whether Blue is also a related party of Egin group.** This would depend on whether the director is considered key management personnel at a group level. The director's services as a consultant to the group may mean that a related party relationship exists. The issue would depend on whether this role meant that this person was directing or controlling a major part of the group's activities and resources.

Between Spade and the Egin Group

Spade is a related party of Doye because it exerts **significant influence** over Doye. This means that the **sale** of plant and equipment **to Spade must be disclosed. Egin is not necessarily a related party of Spade** simply because both have an investment in Doye. A related party relationship will only exist if one party **exercises influence** over another **in practice**.

The directors have proposed that disclosures should state that prices charged to related parties are set on an **arm's length basis**. Because the transaction took place **between related parties** by definition it **cannot have taken place on an arm's length basis** and this description cannot be substantiated and would be **misleading.** Doye sold plant and equipment to Spade at **normal selling prices** and this is the information that should be disclosed, provided the terms can be substantiated.

Between Atomic and the Egin Group

Atomic is a related party of Egin because it can exercise **significant influence** over it. Atomic's significant influence over Egin gives it **significant influence over Briars and Doye** as they are controlled by Egin. **Eye is not a related party of Atomic** as Atomic has no ability to exercise control or significant influence over Eye.

31 Alexandra

Workbook references. IAS 1 *Presentation of Financial Statements* is covered in Chapter 1 and IFRS 15 *Revenue from Contracts with Customers* in Chapter 3. Financial assets and impairment are covered in Chapter 8. Related parties is covered in Chapter 2. Practice Statement 2 is covered in Chapter 20.

Top tips. Part (a) was on reclassification of long-term debt as current – make sure you are familiar with IAS 1 as it is not a difficult standard but is often overlooked by students – IAS 1 requires a liability to be classified as current if certain conditions are met. In Part (b), for the financial asset, you needed to identify which of the three stages in the credit loss model is appropriate then apply the relevant accounting treatment. Part (c) was on related party disclosures for key management personnel and the effect of Practice Statement 2, which was pretty straightforward if you were familiar with the topic.

Easy marks. Part (c) has some easy marks for applying the definitions from IAS 24 to the scenario.

Marking scheme

				Marks
(a)	(i)	Loan – accounting treatment – 1 mark per point up to	6	
	(ii)	Impact on investors' analysis	3	
				9
(b)	Financial asset			
	•	Classification	3	
	•	Impairment	2	
				5
(c)	Directors remuneration accounting treatment – 1 mark per point up to		4	
	Materiality discussion - 1 mark per point up to		5	
	Importance of disclosure to investors – 1 mark per point up to		2	
				11
				25

(a) (i) **Default on loan**

Under IAS 1 *Presentation of Financial Statements*, a **long-term financial liability** due to be **settled within 12 months** of the year end date should be classified as a **current liability**. Furthermore, a **long-term financial liability** that is payable on **demand** because the entity **breached** a **condition** of its loan agreement should be classified as **current** at the reporting date even if the **lender** has agreed **after the year end**, and **before** the financial statements are **authorised for issue, not** to **demand payment** as a consequence of the breach. This is because, at the reporting date, the entity **does not have the right** to defer settlement for at least 12 months after that date.