

November 20X0	30 April 20X1	17 May 20X1	Date financial statements approved for issue
Condition of loan agreement breached. Long-term liability becomes payable on demand	Reporting date	Lender agrees not to enforce payment resulting from breach	

However, if the **lender** has **agreed** by the **reporting date** to provide a **period of grace** ending **at least 12 months after the year end** within which the entity can rectify the breach and during that time the lender cannot demand immediate repayment, the liability is classified as **non-current**.

In the case of Alexandra, the waiver was given before the reporting date, but only for the loan to be repaid a month after the reporting date, then a further waiver was agreed, but again only for a few weeks. It would **not therefore be appropriate for Alexandra to classify the bond as long-term debt** in the statement of financial position as at 30 April 20X1.

The fact that Alexandra has defaulted and sought two loan waivers may cast doubt on its ability to continue as a going concern, especially as the loan waivers may not be renewed. If there is uncertainty regarding Alexandra's going concern status, IAS 1 requires Alexandra to disclose these uncertainties. If Alexandra ceases to be a going concern, then the financial statements would need to be prepared on a break-up basis.

(ii) *Impact on investors' analysis*

Alexandra's incorrect presentation of this loan could have a serious impact on investors as they seek to analyse the financial statements. Investors need information to help them assess the prospects for future net cash inflows to an entity. Given that the bond obligation may become repayable immediately in this case, Alexandra's ability to continue as a going concern and be able to generate any future cash flows is clearly at risk.

According to the *Conceptual Framework*, the objective of financial reporting is to provide financial information about the entity that is useful to primary users of the financial statements when making decisions about providing resources to the entity. In Alexandra's case, reporting the loan as non-current is not useful to primary users; it is misleading. In fact, it is materially misleading as it could quite feasibly influence the economic decisions the primary users of Alexandra's financial statements make on the basis of those financial statements.

(b) **Financial asset**

The loan is a financial asset held at amortised cost under IFRS 9 *Financial Instruments*. Alexandra wishes to measure the loan at fair value. However, IFRS 9 states that the classification of an instrument is determined on initial recognition and that reclassifications, which are not expected to occur frequently, are permitted only if the entity's business model changes.

Financial assets are subsequently measured at amortised cost if both of the following apply:

- (i) The asset is held within a business model whose objective is to hold the assets to collect the contractual cash flows; and
- (ii) The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding.

All other financial assets are measured at fair value.

Alexandra's objective (and therefore its business model) for holding the debt instrument has not changed, and so it cannot measure it at fair value but must continue to measure it at amortised cost.

As Alexandra has adopted IFRS 9 *Financial Instruments*, it must apply the standard's forward-looking impairment model. The financial statements must reflect the deterioration in the credit quality of the financial asset in order to provide users with more useful and timely information.

As Alexandra has now determined that the credit risk associated with the asset has increased significantly since initial recognition, it must now increase the allowance for credit losses to reflect lifetime expected credit losses.

Alexandra is required to record the full amount of the increased allowance for credit losses immediately to reflect the impairment. The lifetime expected credit losses should be calculated at the present value of expected cash shortfalls arising from all possible default events over the loan's expected life. The allowance should be increased to \$9.9m, and the increase in the allowance of \$7.9m (\$9.9m - \$2m) should be charged to profit or loss.

Interest revenue relating to the loan should continue to be calculated on the gross carrying amount of the loan as it is not considered to be credit impaired.

(c) **Directors' remuneration**

**IAS 24 Related Party Disclosures** requires that entities should **disclose** key management personnel compensation **not only in total** but also **for each of the following categories**:

- Short-term employee benefits
- Post-employment benefits
- Other long-term benefits
- Termination benefits
- Share-based payment

The remuneration for the directors of Alexandra fits into the categories of 'short-term benefits' (ie salary and bonus) and 'share-based payment' (ie share options).

Only totals for each category need to be disclosed, not the earnings of individual board members, so no cultural protocol will be breached by these disclosures. However, Alexandra is a public limited company, and so local legislation and corporate governance rules may require more detailed disclosure.

*Non-executive directors*

IAS 24 defines **key management personnel** as those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (**whether executive or otherwise**) of that entity. Therefore, Alexandra's non-executive directors are members of Alexandra's key management personnel. The requirements of IAS 24 therefore also apply to the non-executive directors' pay.

*Effect of materiality*

Practice Statement 2 reaffirms that if information provided by a disclosure is not material, ie that it could not reasonably be expected to influence the decisions primary users make based on the financial statements, then that disclosure need not be made.

This applies equally to related party disclosures as to any other disclosures required by IFRSs, even if they are required under the Standard as 'minimum disclosures'. So in a sense, the finance director is correct – **but** only if the information provided by those related party disclosures is not material.

How the board assesses whether the information is material is important. The boards' assertion that the 'amounts involved are not material' suggests that perhaps they have only considered materiality from a **quantitative perspective**.



Practice Statement 2 suggests it may be efficient to first assess materiality from a quantitative perspective. If an item is considered immaterial from a quantitative perspective, the entity can then consider the presence of any **qualitative factors** and assess materiality from that perspective.

The involvement of related parties is a qualitative factor. The fact that these transactions are with related parties of Alexandra reduces the quantitative threshold that Alexandra should use to determine if the transactions are material.

Sometimes the effect of a qualitative factor can reduce the quantitative threshold to zero – thus the transaction is material despite how small it might be. This is likely to be the case when considering directors' remuneration given that it is such a contentious area.

As such, Alexandra should make the disclosures required under IAS 24, unless they can provide a well-supported argument as to why the information is not material.

#### *Importance of disclosure to investors*

Disclosures about related parties are necessary to draw attention to the possibility that the entity's financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

Director's remuneration disclosures are particularly contentious. Public concern about excessive director remuneration has existed for some time. Investors want to know how much of an entity's income is being spent on its directors and whether this represents good value for money. Given the default on the bond and waivers to postpone interest payments, it is likely that the company would come under criticism if payments to directors were considered particularly high.

The disclosure of individual components of remuneration is important because it could influence the performance of a director – eg a high early termination payment may be seen to be rewarding poor performance.

## 32 Yanong

**Workbook references.** Fair value measurement is covered in Chapter 4. IFRS 5 is included in Chapter 14.

**Top tips.** The transaction in exhibit 1 required an understanding of the market definitions given in IFRS 13. You are expected to be able to go beyond memorising the valuation inputs. The fair value measurement of the maize (in exhibit 2) was challenging. However, valuation techniques are used extensively in corporate reporting and therefore you must become accustomed to using such techniques in answering questions. Balancing this, the valuation of a non-financial asset (the farmland, exhibit 3) was more straightforward. Exhibit 2 required some knowledge of IAS 41 *Agriculture*, which although not on in the SBR syllabus, is brought forward knowledge from *Financial Reporting*. Do not be put off by this – it is clear from reading the first paragraph of this question that the main focus of the discussion should be on IFRS 13 as per the suggested solution below. IAS 41 would only ever form a very small part of any SBR question. In Part (b) there is no need to spend time giving the IFRS 5 criteria for classification as held for sale, since we are told in the question that these criteria have been met.

**Easy marks.** These are available for identifying which standards apply and outlining the principles applicable, and you will gain these marks whether or not you come to the correct conclusion about the accounting treatment.

## Marking scheme

		Marks
(a)	(i) 1 mark per point up to maximum	6
	(ii) 1 mark per point up to maximum	7
	(iii) 1 mark per point up to maximum	5
(b)	1 mark per point up to maximum	7
		<u>25</u>

### (a) (i) Fair value of agricultural vehicles

IFRS 13 says that fair value is an exit price in the principal market, which is the market with the highest volume and level of activity. It is not determined based on the volume or level of activity of the reporting entity's transactions in a particular market. Once the accessible markets are identified, market-based volume and activity determines the principal market. There is a presumption that the principal market is the one in which the entity would normally enter into a transaction to sell the asset or transfer the liability, unless there is evidence to the contrary. In practice, an entity would first consider the markets it can access. In the absence of a principal market, it is assumed that the transaction would occur in the most advantageous market. This is the market which would maximise the amount which would be received to sell an asset or minimise the amount which would be paid to transfer a liability, taking into consideration transport and transaction costs. In either case, the entity must have access to the market on the measurement date. Although an entity must be able to access the market at the measurement date, IFRS 13 does not require an entity to be able to sell the particular asset or transfer the particular liability on that date. If there is a principal market for the asset or liability, the fair value measurement represents the price in that market at the measurement date regardless of whether that price is directly observable or estimated using another valuation technique and even if the price in a different market is potentially more advantageous.

The principal (or most advantageous) market price for the same asset or liability might be different for different entities and therefore, the principal (or most advantageous) market is considered from the entity's perspective which may result in different prices for the same asset.

In Yanong's case, Asia would be the principal market as this is the market in which the majority of transactions for the vehicles occur. As such, the fair value of the 150 vehicles would be \$5,595,000 ( $\$38,000 - \$700 = \$37,300 \times 150$ ). Actual sales of the vehicles in either Europe or Africa would result in a gain or loss to Yanong when compared with the fair value, ie \$37,300. The most advantageous market would be Europe as a net price of \$39,100 (after all costs) would be achieved by selling there. Yanong would therefore utilise the fair value calculated by reference to the Asian market as this is the principal market.

IFRS 13 makes it clear that the price used to measure fair value must not be adjusted for transaction costs but should consider transportation costs. Yanong has currently deducted transaction costs in its valuation of the vehicles. Transaction costs are not deemed to be a characteristic of an asset or a liability but they are specific to a transaction and will differ depending on how an entity enters into a transaction. While not deducted from fair value, an entity considers transaction costs in the context of determining the most advantageous market because the entity is seeking to determine the market which would maximise the net amount which would be received for the asset.



(ii) **Accounting treatment of maize**

Where reliable market-based prices or values are not available for a biological asset in its present location and condition, fair value should be measured using a valuation technique. Relevant observable inputs should be maximised whilst unobservable inputs should be minimised. An appropriate valuation technique would be the present value of expected net cash flows from the asset, discounted at a current market-based rate. In the measurement of fair value of growing crops, a notional cash flow expense should be included for the 'rent' of the land where it is owned in order that the value is comparable to an entity which rents its land. The fair value of the biological asset is separate from the value of the land on which it grows.

	3 months to 31 January 20X5 \$m	3 months to 30 April 20X5 \$m	Total \$m
Cash inflows		80	80
Cash outflows	(8)	(19)	(27)
Notional rental charge for land	<u>(1)</u>	<u>(1)</u>	<u>(2)</u>
Net cash flows	(9)	60	51
Discounted at 2%	(8.82)	57.66	48.84

Thus, in the quarterly accounts at 31 October 20X4, the maize fields should be recognised at \$68.84 million (\$20 million land plus \$48.84 million maize). A fair value gain of \$48.84 million should be shown in profit or loss less the operating costs of \$10 million.

At 31 January, Yanong has revised its projections for cash inflows to \$76 million, which means that the net cash flows at that date were projected to be \$(76 – 19 – 1) million, ie \$56 million. Discounted at 2%, this amounts to \$54.9 million. Thus, a fair value gain of \$(54.9 – 48.84) million, ie \$6.06 million, should be shown in profit or loss together with the actual operating costs of \$8 million.

At the point of harvest, on 31 March 20X5, the maize is valued at \$82 million which means that a fair value gain of \$(82 – 54.9) million, ie \$27.1 million, is recognised in profit or loss and the maize is classified as inventory. The actual operating costs for the quarter would also be shown in profit or loss. When the maize is sold, a further profit of \$(84 – 82) million, ie \$2 million, is made on the sale.

(iii) **Farmland**

A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant who would use the asset in its highest and best use. The maximum value of a non-financial asset may arise from its use in combination with other assets or by itself. IFRS 13 requires the entity to consider uses which are physically possible, legally permissible and financially feasible. The use must not be legally prohibited. In this case, Yanong's land for residential development would only require approval from the regulatory authority and that approval seems to be possible, so this alternative use could be deemed to be legally permissible. Market participants would consider the probability, extent and timing of the approval which may be required in assessing whether a change in the legal use of the non-financial asset could be obtained.

Yanong would need to have sufficient evidence to support its assumption about the potential for an alternative use, particularly in light of IFRS 13's presumption that the highest and best use is an asset's current use. Yanong's belief that planning permission was possible is unlikely to be sufficient evidence that the change of use is legally permissible. However, the fact the government has indicated that more agricultural land should be released for residential purposes may provide additional evidence as to the likelihood that the land being measured should be based upon residential value. Yanong would need to prove that market participants would consider residential use of the land to be legally permissible. Provided there is

sufficient evidence to support these assertions, alternative uses, for example, commercial development which would enable market participants to maximise value, should be considered, but a search for potential alternative uses need not be exhaustive. In addition, any costs to transform the land, for example, obtaining planning permission or converting the land to its alternative use, and profit expectations from a market participant's perspective should also be considered in the fair value measurement.

If there are multiple types of market participants who would use the asset differently, these alternative scenarios must be considered before concluding on the asset's highest and best use. It appears that Yanong is not certain about what constitutes the highest and best use and therefore IFRS 13's presumption that the highest and best use is an asset's current use appears to be valid at this stage.

- (b) The criteria in IFRS 5 have been met for North and South. As the assets are to be disposed of in a single transaction, North and South together are deemed to be a **disposal group** under IFRS 5.

The disposal group as a whole is **measured as non-current assets held for sale**. Before the manufacturing units are classified as held for sale, impairment is tested for on an individual cash-generating unit basis. Any impairment loss reduces the carrying amount of the non-current assets in the disposal group, the loss being allocated in the order required by IAS 36 *Impairment of Assets*. Once classified as held for sale, the impairment testing is done on a **disposal group basis**.

A disposal group that is held for sale should be measured at the **lower of its carrying amount and fair value less costs to sell**. Any impairment loss is generally recognised in profit or loss, but if the asset has been measured at a revalued amount under IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*, the impairment will be treated as a revaluation decrease.

A **subsequent increase** in fair value less costs to sell may be **recognised** in profit or loss **only to the extent of any impairment previously recognised**. To summarise:

- Step 1** Calculate carrying amount under the individual standard, here given as \$105 million.
- Step 2** Classified as held for sale. Compare the carrying amount (\$105m) with fair value less costs to sell (\$125m). Measure at the lower of carrying amount and fair value less costs to sell, here \$105 million.
- Step 3** Determine fair value less costs to sell at the year end (see below) and compare with carrying amount of \$105 million.

Yanong has not taken account of the increase in fair value less cost to sell, but only part of this increase can be recognised, calculated as follows.

	\$m
Fair value less costs to sell: North	40
Fair value less costs to sell: South	95
	<u>135</u>
Carrying amount	<u>(105)</u>
Increase	<u>30</u>

Impairment previously recognised in North: \$15m (\$50m – \$35m)

- Step 4** The change in fair value less cost to sell is recognised but the gain recognised cannot exceed any impairment losses to date. Here the gain recognised is \$50m – \$35m = \$15m

Therefore, **carrying amount can increase** by \$15 million to \$120 million as loss reversals are limited to impairment losses previously recognised (under IFRS 5 or IAS 36).



## 33 Avco

**Workbook reference.** The distinction between debt and equity is covered in Chapter 8. Cryptocurrencies are covered in Chapter 20.

**Top tips.** The majority of the question covers the distinction between debt and equity, which is quite narrow in focus. The topic has featured in an article by the examining team which is available on ACCA's website. The distinction between debt and equity is fundamental to any set of financial statements, and it is essential that you can explain it with reference to IFRSs and the *Conceptual Framework*. In Part (c), accounting for cryptocurrencies is an emerging issue that the IASB has not yet issued any guidance on. You should critically assess the finance director's suggestion that these are financial assets by reference to relevant Standards and the *Conceptual Framework*.

**Easy marks.** This is a challenging question overall but you should understand and be able to discuss the basic principles of debt v equity.

### Marking scheme

	Marks
(a) 1 mark per point up to maximum	8
(b) (i) 1 mark per point up to maximum	8
(b) (ii) Effects	4
(c) 1 mark per point up to maximum	5
	<u>25</u>

#### (a) Cavor

##### B shares

The classification of Cavor's B shares will be made by applying **the principles-based definitions of equity and liability in IAS 32 Financial Instruments: Presentation**, and considering the **substance**, rather than the legal form of the instrument. 'Substance' here relates only to consideration of the contractual terms of the instrument. Factors outside the contractual terms are not relevant to the classification. The following factors demonstrate that Cavor's B shares are **equity instruments**.

- (1) **Dividends are discretionary** in that they need only be paid if paid on the A shares, on which there is no obligation to pay dividends. Dividends on the B shares will be paid at the same rate as on the A shares, which will be variable.
- (2) Cavor has **no obligation to redeem** the B shares.

##### Lidan

A financial liability under IAS 32 is **a contractual obligation to deliver cash or another financial asset to another entity**. The contractual obligation may arise from a requirement to make payments of principal, interest or dividends. The contractual obligation may be explicit, but it may be implied indirectly in the terms of the contract.

In the case of Lidan, the **contractual obligation is not explicit**. At first glance it looks as if Lidan has a choice as to how much it pays to redeem the B shares. However, the conditions of the financial instrument are such that the value of the **settlement in own shares is considerably greater than the cash settlement obligation**. The effect of this is that **Lidan is implicitly obliged to redeem the B shares at for a cash amount of \$1 per share**. The own-share settlement alternative is uneconomic in comparison to the cash settlement alternative and cannot therefore serve as a means of avoiding classification as a liability.

IAS 32 states further that where a derivative contract has settlement options, **all of the settlement alternatives must result in it being classified as an equity instrument**, otherwise it is a financial asset or liability.

In conclusion, **Lidan's B shares must be classified as a liability**

(b) (i) **Classification differences between debt and equity**

The distinction between debt and equity in an entity's statement of financial position is not easily distinguishable for preparers of financial statements. Some financial instruments may have features of debt and of equity, which can lead to inconsistency of reporting which can be confusing for the users of financial statements.

IAS 32 requires the **classification to be based on principles** rather than driven by perceptions of users.

IAS 32 defines an **equity instrument** as: 'any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities' (para. 11). It must first be **established that an instrument is not a financial liability**, before it can be classified as equity.

A key feature of the **IAS 32 definition of a financial liability** is that it is a **contractual obligation to deliver cash or another financial asset to another entity**. The contractual obligation may arise from a requirement to make payments of principal, interest or dividends. The contractual obligation may be explicit, but it may be implied indirectly in the terms of the contract. An example of a debt instrument is a bond which requires the issuer to make interest payments and redeem the bond for cash.

A financial instrument is an **equity instrument** only if there is no obligation to deliver cash or other financial assets to another entity and if the instrument will or may be settled in the issuer's own equity instruments. An example of an equity instrument is **ordinary shares, on which dividends are payable at the discretion of the issuer**. A less obvious example is preference shares required to be converted into a fixed number of ordinary shares on a fixed date or on the occurrence of an event which is certain to occur.

An instrument may be classified as an equity instrument if it contains a **contingent settlement provision** requiring settlement in cash or a variable number of the entity's own shares **only on the occurrence of an event which is very unlikely to occur** – such a provision is **not considered to be genuine**. If the **contingent payment condition** is **beyond the control** of both the entity and the holder of the instrument, then the instrument is classified as a **financial liability**.

A contract resulting in the receipt or delivery of an entity's own shares is **not automatically an equity instrument**. The classification depends on the so-called '**fixed test**' in IAS 32. A contract which will be settled by the entity receiving or delivering a **fixed number of its own equity instruments in exchange for a fixed amount of cash** is an equity instrument. In contrast, if the **amount of cash or own equity shares to be delivered or received is variable**, then the contract is a **financial liability or asset**.

There are **other factors** which might result in an instrument being **classified as debt**.

- (1) Dividends are non-discretionary.
- (2) Redemption is at the option of the instrument holder.
- (3) The instrument has a limited life.
- (4) Redemption is triggered by a future uncertain event which is beyond the control of both the issuer and the holder of the instrument.

**Other factors** which might result in an instrument being **classified as equity** include the following.

- (1) Dividends are discretionary.
- (2) The shares are non-redeemable.
- (3) There is no liquidation date.



Although IAS 32 establishes principles for presenting financial instruments as liabilities or equity, it is not always easy to apply these principles in practice.

(ii) **Significance of debt/equity classification for the financial statements**

The distinction between debt and equity is very important for users who analyse the financial statements. The classification **can have a significant impact on the entity's reported earnings and gearing ratio**, which in turn can affect investment decisions. Companies may wish to classify a financial instrument as **equity**, in order to give a **favourable impression of gearing**, but this may in turn have a **negative effect** on the perceptions of existing shareholders if it is seen **as diluting existing equity interests**.

The distinction is also relevant in the context of a **business combination** where an entity **issues financial instruments as part consideration, or to raise funds to settle a business combination in cash**. Management is often called upon to **evaluate different financing options**, and in order to do so must **understand the classification rules and their potential effects**. For example, **classification as a liability** generally means that **payments are treated as interest** and charged to profit or loss, and this may, in turn, **affect the entity's ability to pay dividends** on equity shares.

- (c) The finance director has suggested that the investment in cryptocurrencies should be recorded as a financial asset. Under IAS 32, a financial asset is 'cash, an equity instrument of another entity or a contractual right to receive cash, an equity instrument or exchange financial instruments on favourable terms' (para. 11). Cryptocurrencies do not meet the definition of cash as they are not generally accepted as legal tender and also do not give a contractual right to receive cash or other instruments. As such, it is not appropriate for Avco to classify the investment as a financial asset.

In the absence of an IFRS Standard covering investments in cryptocurrencies, the directors of Avco should use judgement to develop an appropriate accounting policy in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The directors should consider:

- IFRS Standards dealing with similar issues. As we have discussed, cryptocurrencies do not meet the definition of financial assets and they do not have physical substance and therefore cannot be accounted for as property, plant and equipment or inventories. As cryptocurrencies do not have physical substance, it is likely that IAS 38 *Intangible Assets* is the most appropriate accounting standard to refer to. They also meet the other criteria of IAS 38 as they are identifiable and they are non-monetary (as they do not result in fixed or determinable amounts of money).
- The *Conceptual Framework*. The investment appears to meet the definition of an asset: a present economic resource controlled by the entity as a result of past events. Consideration should be given to the recognition criteria and to other issues such as the measurement basis to apply and how measurement uncertainty may affect that choice given the volatility of cryptocurrencies.
- The most recent pronouncements of other national GAAPs based on a similar conceptual framework and accepted industry practice. The IFRS Interpretations Committee issued an agenda decision in 2019 in which they defined what they meant by a 'cryptocurrency' and concluded that items which met this definition should be treated as intangible assets. The directors should consider whether the investment they hold meets the definition of cryptocurrency as defined in the agenda decision, and if so, should apply the guidance in the agenda decision.

The directors of Avco need to account for the investment in a way which provides **useful** information to the primary users of its financial statements. This means the information provided by the accounting treatment should be **relevant** and should **faithfully represent** the investment.

## 34 Lupin

**Workbook references.** Current and deferred tax is covered in Chapter 7. IFRS 2 is covered in Chapter 10 and IFRS 16 in Chapter 9. Materiality is covered in Chapter 20.

**Top tips.** Part (a) is asking you to apply the requirements of IAS 12 to four different items including share options, a leasing transaction, an intra group sale and an impairment of property, plant and equipment. Part (b)(i) can be broken down into its component parts of discussion of the *Conceptual Framework* and temporary differences, and credit is available for fairly general discussion of both. In (b)(ii) the tax reconciliation is intended to be useful in helping stakeholders to understand the income tax expense in the statement of profit or loss and cannot be omitted just because it is complex to prepare.

**Easy marks.** Part (a)(iii) and (iv) are easier than (i) and (ii), though they carry the same number of marks.

### Marking scheme

			Marks
(a)	(i)	Share options	4
	(ii)	Lease plant	4
	(iii)	Intragroup	4
	(iv)	Impairment loss	4
			<u>16</u>
(b)	(i)	Conceptual Framework	2
		Temporary difference	2
		Liability	1
			<u>5</u>
	(ii)	Tax reconciliation discussion	2
		Omit from disclosures	2
			<u>4</u>
Total			<u>25</u>

#### (a) (i) Share options

Under IFRS 2 *Share-based Payment* the company **recognises an expense** for the employee services received in return for the share options granted over the vesting period. The related tax deduction **does not arise until the share options are exercised**. Therefore, a **deferred tax asset arises**, based on the difference between the intrinsic value of the options and their carrying amount (normally zero).

At 31 October 20X4 the tax benefit is as follows:

	\$m
Carrying amount of share-based payment	–
Less tax base of share-based payment (16/2)	(8)
Temporary difference	<u>(8)</u>

The **deferred tax asset is \$2.4 million** ( $30\% \times 8$ ). This is recognised at 31 October 20X4 provided that taxable profit is available against which it can be utilised. Because the tax effect of the remuneration expense is greater than the tax benefit, the tax benefit is **recognised in profit or loss**. (The tax effect of the remuneration expense is  $30\% \times \$40 \text{ million} \div 2 = \$6 \text{ million}$ .)



At 31 October 20X5 there is **no longer a deferred tax asset** because the options have been exercised. The **tax benefit receivable is \$13.8 million** ( $30\% \times \$46 \text{ million}$ ). Therefore, the deferred tax asset of \$2.4 million is no longer required.

(ii) **Leased plant**

Under IFRS 16 Leases, a **right-of-use asset** and a **lease liability** are recognised.

The lease liability is measured at the **present value of future lease payments** discounted using, if available, the interest rate implicit in the lease. Each instalment payable is allocated partly as interest and partly as repayment of the liability.

The right-of-use asset is measured initially at the amount of the initial measurement of the lease liability, plus certain other direct costs not incurred in this case, such as legal fees. It is depreciated on a straight-line basis over the five years. The **carrying amount** of the right-of-use asset for accounting purposes is the **initial amount of the right-of-use asset less depreciation**.

Tax relief is granted as lease rentals are paid, therefore the tax base of the lease liability is zero as it is calculated as the carrying amount less any future tax-deductible amounts. The tax base of the right-of-use asset is the amount deductible for tax in future, which is zero.

Therefore, at 31 October 20X5 a **net temporary difference** arises as follows:

	\$m	\$m
Carrying amount in financial statements:		
Asset:		
Right-of-use asset	12.00	
Less depreciation (12/5)	<u>(2.40)</u>	
		9.60
Less lease liability		
Liability at inception of lease	12.00	
Interest ( $8\% \times 12$ )	0.96	
Lease rental	<u>(3.00)</u>	
		<u>(9.96)</u>
		0.36
Less tax base		<u>(0.00)</u>
Temporary difference		<u>0.36</u>

A **deferred tax asset of \$108,000** ( $30\% \times 360,000$ ) arises.

(iii) **Intra-group sale**

Dahlia has **made a profit of \$2 million** on its sale to Lupin. Tax is **payable on the profits of individual companies**. Dahlia is liable for tax on this profit in the current year and will have provided for the related tax in its individual financial statements. However, **from the viewpoint of the group the profit will not be realised until the following year**, when the goods are sold to a third party and must be **eliminated** from the consolidated financial statements. Because the group **pays tax before the profit is realised** there is a **temporary difference of \$2 million** and a **deferred tax asset of \$600,000** ( $30\% \times \$2 \text{ million}$ ).

(iv) **Impairment loss**

The impairment loss in the financial statements of Nala **reduces the carrying amount** of property, plant and equipment, but is **not allowable for tax**. Therefore, the **tax base** of the property, plant and equipment is **different from its carrying amount** and there is a **temporary difference**.

Under IAS 36 *Impairment of Assets* the impairment loss is allocated first to goodwill and then to other assets:

	Goodwill	Property, plant and equipment	Total
	\$m	\$m	\$m
Carrying amount at 31 October 20X5	1	6.0	7.0
Impairment loss	(1)	(0.8)	(1.8)
	<u>—</u>	<u>5.2</u>	<u>5.2</u>

IAS 12 states that **no deferred tax should be recognised on goodwill** and therefore **only the impairment loss relating to the property, plant and equipment affects the deferred tax position.**

- (b) (i) The conceptual basis for accounting for deferred tax is questionable.

On one hand, deferred tax is focused on the statement of financial position, which is in keeping with the *Conceptual Framework*. However, it can be argued that deferred tax assets and liabilities **do not meet the definition of assets and liabilities** under the *Conceptual Framework*. An asset is defined as a **present economic resource** controlled by an entity as a result of past events and a liability is a **present obligation** to transfer economic benefits, again as a result of past events. It is not clear whether deferred tax assets and obligations can be considered present resources or obligations.

IAS 12 *Income Taxes* is based on the idea that **all changes in assets and liabilities** have **unavoidable tax consequences**. Where the recognition criteria in IFRS are different from those in tax law, **the carrying amount of an asset or liability in the financial statements is different from its tax base** (the amount at which it is stated for tax purposes). These differences are known as **temporary differences**.

The practical effect of these differences is that the recognition of the transaction or event occurs in a different accounting period from its tax consequences. For example, unless the accounting depreciation and tax depreciation (capital allowances in the UK) are calculated on exactly the same basis, the amount of accounting depreciation recognised in the financial statements in an accounting period is different to the amount of tax on the same asset in the same period.

Under IAS 12, the tax effects of transactions are recognised in the same period as the transactions themselves, but in practice, tax is paid in accordance with tax legislation when it becomes a legal liability. This is considered another **conceptual weakness** or inconsistency, in that only one liability, that is tax, is being provided for, and not other costs, such as overhead costs that may be associated with the same transaction.

#### Conclusion

The shareholder is correct to question the basis for providing for deferred tax as there does appear to be some inconsistency between IAS 12 and the *Conceptual Framework*. Nonetheless, Lupin should apply the requirements of IAS 12.

- (ii) The tax reconciliation shows how the tax charge in the statement of profit or loss can be reconciled back to the expectation of some users of financial statements that income tax is simply a company's profit before tax multiplied by the applicable tax rate.

It is true that the tax reconciliation can be complicated. This is particularly the case when the tax affairs of the entity are complex. However, this does not mean that the information should be excluded. The *Conceptual Framework* states that excluding information about complex phenomena from financial statements might make the financial statements easier to understand, but it would also make them incomplete and therefore potentially misleading.



The *Conceptual Framework* expects users of financial statements to have a reasonable knowledge of business and economic activities. Lupin should consider whether this is the case for this particular shareholder. However, if several shareholders are complaining about the tax reconciliation, then Lupin could consider including an explanatory note to the tax reconciliation to enable users of the financial statements to fully understand it. While this is not required by IAS 12, IAS 1 requires entities to consider whether additional information should be presented to enable users to understand the impact of transactions or conditions on the entity's financial position or performance.

The fact that the finance director finds the tax reconciliation difficult to prepare is not a valid reason for omitting it. In fact, the finance director's comment raises ethical concerns – is the finance director competent and aware of the requirements of IFRS? The tax reconciliation is a key disclosure required by IAS 12. That is not to say that all disclosures required by an accounting standard must be given – it depends on whether the disclosure is material.

IFRS Practice Statement 2 *Making Materiality Judgements* requires a preparer to make materiality judgements and clarifies that if information provided by a disclosure could not reasonably be expected to influence the decisions users make based on the financial statements, then that disclosure need not be made.

Given that the finance director finds it difficult to prepare the reconciliation suggests that Lupin's tax affairs may be complex and therefore disclosing information about them is unlikely to be immaterial.

## 35 Janne

**Workbook references.** Investment property and fair value measurement are covered in Chapter 4. IFRS Practice Statement 2 *Making Materiality Judgements* is covered in Chapter 20. Alternative performance measures are covered in Chapter 18.

**Top tips.** For Part (a)(i) ensure that you relate your answer to the relevant accounting standards, IAS 40 and IFRS 13. The key message is that there is guidance on the measurement of fair value which Janne should have been applying. In Part (a)(ii) requires a discussion of the measurement principles in the *Conceptual Framework* in relation to Janne.

In Part (b) you need to make sure you answer the requirement: relate your answer to Janne's investors and reference the key applicable points of the practice statement. Part (c) covers alternative performance measures which is a key topic for SBR. Again, you need to consider Janne's investors in your answer. Wider reading of articles, particularly those on the ACCA website, will be extremely helpful in being able to answer questions such as those seen here in Parts (b) and (c). The ESMA (European Securities and Markets Authority) Guidelines on Alternative Performance Measures, which are available online, provide another perspective and will be beneficial to read.

### Marking scheme

	Marks
(a) Investment properties discussion – 1 mark per valid point up to	9
(b) Annual report discussion – 1 mark per valid point up to	8
(c) Alternative performance measure discussion – 1 mark per valid point up to	8
	<u>25</u>

(a) (i) **Investment properties**

IAS 40 *Investment Property* allows two methods for valuing investment property: the fair value model and the cost model. If the fair value model is adopted, **then the investment property must be valued in accordance with IFRS 13 Fair Value Measurement**. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Fair value is a **market-based measurement** rather than specific to the entity, so a company is not allowed to choose its own way of measuring fair value. Valuation techniques must be those which are appropriate and for which sufficient data are available. Entities should maximise the use of relevant **observable inputs** and minimise the use of **unobservable inputs**. The standard establishes a hierarchy for the inputs that valuation techniques use to measure fair value.

- |                |   |
|----------------|---|
| <b>Level 1</b> | Quoted prices (unadjusted) in active markets for identical assets or liabilities  |
| <b>Level 2</b> | Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly |
| <b>Level 3</b> | Unobservable inputs for the asset or liability  |

Although the directors claim that 'new-build value less obsolescence' is accepted by the industry, it **may not be in accordance with IFRS 13**. As investment property is often unique and not traded on a regular basis, fair value measurements are likely to be categorised as Level 2 or Level 3 valuations.

IFRS 13 mentions three valuation techniques: the market approach, the income approach and the cost approach. A market or income approach would usually be more appropriate for an investment property than a cost approach. The 'new-build value less obsolescence' (cost approach) does not take account of the Level 2 inputs such as sales value (market approach) and market rent (income approach). Nor does it take account of reliable estimates of future discounted cash flows, or values of similar properties.

In conclusion, Janne must apply IFRS 13 to the valuation of its investment property, taking account of Level 2 inputs.

(ii) **Selection of measurement basis**

Janne should ensure that it has given adequate consideration to its particular facts and circumstances in deciding to use fair value as the measurement basis for its investment property.

Applying the principles in the *Conceptual Framework*, Janne should choose a measurement basis should that provides information that is **useful** to the primary users of its financial statements. To be useful, the information must be **relevant** and provide a **faithful representation**.

The relevance of a measurement basis is affected by:

- The characteristics of the asset – eg if information about changes in the value of investment property is important to Janne's primary users, using a cost basis may not provide relevant information.
- How the asset contributes to future cash flows – which in part depends on Janne's business activities.

As investment property makes up 60% of Janne's total assets and assuming that Janne is holding investment property both to obtain rental income and to benefit from increases in value, it would be reasonable to assume that primary users would be very interested in changes in value, suggesting cost may not provide the most relevant information.



However, sometimes the level of **measurement uncertainty** associated with a measurement basis is so high that the information would not be a faithful representation. If significant measurement uncertainty exists through the use of fair value, Janne should consider using cost instead. This principle is also included in IAS 40 as it specifies that if, at recognition, fair value is not expected to be reliably measurable on a continuing basis, cost should be used instead.

(b) **Annual report**

Too much information in annual reports can be problematic as it can **obscure relevant information** and prevent investors from identifying the key issues that are likely to affect their decisions.

Removing unnecessary information from the annual report is therefore a good idea. However, it must be done carefully to ensure that financial reports still meet their primary objective of providing financial information that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

Disclosures are prescribed by IFRS and therefore are **not optional**. Management cannot just determine which disclosures appear irrelevant.

However, **materiality** needs to be taken into account when making disclosures. Practice Statement 2 *Making Materiality Judgements* confirms that **disclosure does not need to be made, even when prescribed by an IFRS, if the resulting information presented is not material**.

Although the finance director has used a disclosure checklist and determined that all disclosures made were 'necessary', it is not clear whether an assessment has been made as to whether the disclosures provide information that is material. If not, there is the potential to reduce disclosure in Janne's annual report.

If the information provided by a disclosure could not reasonably be expected to influence the decisions primary users make on the basis of Janne's financial statements, then it is not material and does not need to be disclosed.

Reducing the size of the accounting policy note is a distinct possibility. Only significant accounting policies are required to be disclosed by IAS 1. Determining what constitutes a significant accounting policy requires judgement.

Janne could consider removing the accounting policies which would not affect a user's understanding of the financial statements if they were not disclosed. Accounting policies that require management judgement are likely to be material and if so, should be clearly presented. This is so that investors can see where management judgement has been applied and can assess management's stewardship.

Disclosures required by IAS 24 in relation to related parties are necessary to draw attention to the possibility that an entity's financial position and profit or loss may have been affected by the transactions with related parties. So the managing director is not correct in his assertion that because the transactions are undertaken on terms equivalent to 'arm's length', they are not important to investors.

However, as with other disclosures, they only need to be made if the information provided is material. Related party transactions may be of a relatively small size and therefore considered not material from a **quantitative perspective**. However, Practice Statement 2 considers the fact that the transaction is with a related party to be a **qualitative factor**. A qualitative factor reduces the threshold for assessing whether something is material from a quantitative perspective.

Without considering the transactions more carefully, Janne cannot say that related party transactions are immaterial and need not be disclosed. Conversely, Janne should not assume that just because the transaction is with a related party that it must definitely be disclosed. Janne should apply the guidance provided in Practice Statement 2 in order to make a judgement about what information about related party transactions would be useful to investors and other primary users.



(c) **Additional performance measure**

'Adjusted net asset value per share' (adjusted NAV per share) is an additional performance measure (APM). Entities are increasingly reporting APMs in addition to IFRS performance measures, such as earnings per share, in order to enhance a user's understanding of the financial statements. It is possible for Janne to present this APM, however, it cannot present this measure instead of earnings per share (EPS). EPS is required by IAS 33 which must be applied by listed entities. Therefore, in order to comply with IFRS, EPS and diluted EPS must be presented.

APMs should be provided to enhance the understanding of users of the accounts. Investment properties are likely to form the majority of Janne's assets. Therefore, management will be interested in the increase in the value of those properties and related finance (eg loans), both of which are taken into account in adjusted NAV per share. Disclosing adjusted NAV per share should therefore enhance the understanding of investors as it will allow them to evaluate Janne through the eyes of management. Additionally, as adjusted NAV per share is used by other companies in the same industry, disclosing it should allow investors to more effectively compare the performance of Janne with other companies in the same industry.

However, APMs can also be misleading. Unlike EPS, there is no official definition of adjusted NAV per share, so management can choose what items to include in the 'adjustment'. Therefore, it is open to bias in its calculation as management could decide to only adjust for items that improve the measure. In order to counter the criticisms, management should provide a description of what is included when arriving at adjusted NAV per share and ideally reconcile the information back to the IFRS information included within the financial statements. Similarly, in order to be useful, the basis of the calculation needs to be consistent from year to year, otherwise comparison between years will be inaccurate. Furthermore, different companies may define the same measure in different ways, which reduces the comparability between entities.

Ultimately adjusted NAV per share will only provide useful information to Janne's investors if it is fairly presented. The European Securities and Markets Authority (ESMA) has developed guidelines that address the issues surrounding the use of APMs. The guidelines require appropriate description of APMs, consistency in how the APM is calculated and presented from year to year as well as guidance for presentation, including that APMs should not be presented with more prominence, emphasis or authority than the equivalent IFRS measures, nor should they distract from IFRS disclosures.

It is advisable for Janne's directors to consider this guidance in determining whether to present adjusted NAV per share and how it should be presented. They should also consider whether providing further information in the form of APMs will result in more information being reported in the annual report which they are otherwise attempting to reduce.

## 36 SunChem

**Workbook references.** IAS 24 is covered in Chapter 2, IAS 38 in Chapter 4, IFRS 3 in Chapter 11 and IFRS Practice Statement 2 in Chapter 20.

**Top tips.** Part (a) deals with standards that should be familiar to you, but the issues require in-depth consideration. In particular, you need to consider how IAS 38 and IFRS 3 interact, focusing on the implications of acquiring technology, outlining the fact that the probability recognition criterion is always considered to be satisfied for intangible assets that are acquired separately or in a business combination. You were also expected to discuss that a shell company without employees (and hence without processes required to make it a 'business') is an asset acquisition as opposed to a business combination. Part (b) is on materiality and related parties – identifying the related parties and discussing how such disclosures are useful to investors. You are advised to jot down a plan or diagram of the relationships before launching into your answer.

**Easy marks.** There are marks for knowing the basics of the standards tested, but those marks will not get you a pass on this question.



## Marking scheme

	Marks
(a) 1 mark per point up to maximum	10
(b) (i) 1 mark per point up to maximum	4
(ii) 1 mark per point up to maximum	5
(iii) 1 mark per point up to maximum	6
	<u>25</u>

### (a) *Intangible asset*

SunChem has purchased a license which gives it the **right** to use Jomaster's technology for a specified period of time in order to manufacture a specific compound. The acquired license meets the definition of an intangible asset as it is:

- **Identifiable** (it arises from the contractual right to use Jomaster's technology for three years);
- Non-monetary; and
- Has no physical substance (SunChem has not acquired a physical item of machinery, but instead has acquired the right to use the technology to perform a particular process).

Under IAS 38, an intangible asset should be recognised when

- It is probable that the future economic benefits which are attributable to the asset will flow to the entity; and
- The cost of the asset can be measured reliably.

IAS 38 states that the probability recognition criterion is **always considered to be satisfied for intangible assets that are acquired separately** or in a business combination. This is because the price an entity pays to separately acquire an intangible asset will reflect the entity's expectations about the probability of economic benefits flowing to the entity. Put simply, by purchasing the intangible asset, SunChem expects economic benefits to flow from it, even if it is not certain about the timing or amount of those benefits.

**Therefore, SunChem should recognise the license as an intangible asset measured at its cost of \$4 million.** As it has a finite useful life, the license should be **amortised** from the date it is available for use, ie when the manufacturing of the compound begins. The amortisation should be included as an expense in the statement of profit or loss.

At the end of each reporting period, SunChem should assess whether there is any indication that the asset may be **impaired**, and if so, the carrying amount of the asset should be reduced and the impairment loss should be recognised as an expense in profit or loss.

Due to the nature of intangible assets, **subsequent expenditure** will only rarely meet the criteria for being recognised in the carrying amount of an asset. Thus, SunChem should expense its own internal development expenditure, incurred in updating the technology in accordance with Jomaster's requirements, until the criteria for capitalisation in IAS 38 are met and economic benefits are expected to flow to the entity from the capitalised asset.

### *Acquisition of interest in Conew*

SunChem wishes to acquire 65% of the equity of Conew. SunChem must assess whether this acquisition qualifies as a business combination under IFRS 3 *Business Combinations*. A business combination is a transaction in which an entity **obtains control of a business**.

Under IFRS 3, a business consists of **inputs** and **processes applied to those inputs** which have the ability to contribute to the **creation of outputs**.

Conew has an 'input' in that it has an intangible asset. However, Conew does not have any employees, and therefore does not have any processes which could be applied to the intangible asset. Therefore, Conew **does not meet the definition of a business**.

The acquisition of an interest in Conew is therefore an **asset acquisition**, not a business combination, and should be accounted for under IAS 38.

(b) (i) **Materiality**

Practice Statement 2 was developed in response to concerns that some companies are unsure how to make judgements concerning materiality. This can result in excessive disclosure of immaterial information while important information can be obscured or even missed out of the financial statements.

This is particularly true for information disclosed in the notes where it appears that some companies use IFRS disclosure requirements as a 'checklist' and therefore provide all disclosures required by a Standard, whether material or not.

Practice Statement 2 is not an IFRS and is therefore **not mandatory** in order to state compliance with IFRS in a financial report.

*Key points*

- Financial statements are not intended to satisfy the information needs of **all users**, but should provide financial information that is useful to **primary users** (potential and existing investors, lenders and other creditors) in making decisions about providing resources to the entity.
- If the information provided by a disclosure is **not material**, the **entity does not need to make that disclosure**.
- Materiality should be assessed from a **qualitative perspective** as well as a **quantitative perspective**. Practice Statement 2 recommends starting from the quantitative perspective and then applying qualitative factors to further assess immaterial items. The presence of a qualitative factor lowers the quantitative threshold for assessing materiality.

Practice Statement 2 contains a four-step process to help entities make materiality judgements: identify, assess, organise and review.

(ii) **Related parties**

A person or a close member of that person's family is a **related party** of a reporting entity if that person:

- Has control or joint control over the reporting entity;
- Has significant influence over the reporting entity; or
- Is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

**Tutorial note.**

You will get very few, if any, marks for writing up the requirements of Standards. The vast majority of marks are available for the application of those requirements to the scenario given. The definition of a related party has been given in this solution for completeness, but you do not need to include this definition in an exam answer.

In SunChem:

- The finance director is a related party, as she owns more than half of the voting power (60%). In the absence of evidence to the contrary, she controls SunChem and is a member of the key management personnel.



- The sales director is also a related party of SunChem as he is a member of the key management personnel and is a close member (spouse) of the family of the finance director.
- Their son is a related party of SunChem as he is a close member (son) of their family.
- The operations director is also a related party as he owns more than 20% of the voting power in SunChem. In the absence of evidence to the contrary, the operations director has significant influence over SunChem and is a member of the key management personnel.

An entity is related to a reporting entity if the entity is controlled or jointly controlled by a person identified as a related party:

- Baleel is a related party because it is controlled by related parties, the finance and sales directors, for the benefit of a close member of their family, ie their son.
- Ocean is a related party because it is controlled by a close family member (spouse) of the operations director (a related party).

In the absence of evidence to the contrary, the third owner of the shares is not a related party. The person is a passive investor who does not appear to exert significant influence over SunChem.

- (iii) IAS 24 requires related party disclosures in order to draw attention to the possibility that an entity's financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

In this case, there is a single investor owning 10% of the shares whose investment may be affected by the related party transactions undertaken.

It is not just investors that are interested in such information. The *Conceptual Framework* states that the objective of financial reports is to provide information that is useful to existing and potential investors, lenders and other creditors of an entity. So it is not just the passive investor that must be considered when determining what to disclose.

Practice Statement 2 clarifies that if information provided by a disclosure could not reasonably be expected to influence the decisions primary users make based on the financial statements, then that disclosure need not be made.

The involvement of related parties is a qualitative factor when assessing materiality. This factor reduces the quantitative threshold and the entity should then go back and re-assess whether the information is material.

In the case of the laptop sold to the son, it is unlikely that this transaction would be material from a quantitative perspective. However, because the transaction is with a related party, the quantitative threshold should be lowered. SunChem should give consideration as to whether disclosing information about this transaction would be useful to its primary users. Given that the transaction is so small and has not reoccurred, it is probably not material.

In the case of the maintenance contract, it may be that the contract is below the quantitative threshold even when this threshold is lowered for the fact that the transaction is with a related party. However, given that the contract is ongoing and that it was awarded to a related party despite being more expensive, suggests that disclosing this information would be useful to primary users.

## 37 Kiki Co

### Marking scheme

			Marks
(a)	(i)	Discussion of relevant principles of revenue recognition	2
		Application to the gift cards issued by Kiki Co	<u>4</u>
			6
	(ii)	Discussion of relevant principles of revenue recognition	2
		Application to the royalty income of Kiki Co	2
		Principle and treatment of the loss allowance	<u>2</u>
			6
(b)		General implications of the measurement choice	2
		Investor perceptions re asset base/SOFP	4
		Investor perceptions re SOPL/performance measures	<u>5</u>
			11
		Professional	<u>2</u>
			<u>25</u>

#### (a) (i) Gift cards

IFRS 15 *Revenue from Contracts with Customers* says that revenue should be recognised when or as a performance obligation is satisfied by transferring the promised good or service to the customer. When a customer buys a gift card they are pre-paying for a product. Revenue cannot be recognised because the entity has not yet transferred control of an asset and so has not satisfied a performance obligation. As such, cash received in respect of gift cards should be initially recognised as a contract liability.

IFRS 15 refers to a customer's unexercised rights as breakage. The guidance for variable consideration is followed when estimating breakage. In other words, the expected breakage is included in the transaction price if it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur once the uncertainty is subsequently resolved. This means that if the company is unable to reliably estimate the breakage amount, then revenue for the unused portion of the gift card is recognised when the likelihood of the customer exercising their remaining rights becomes remote. However, if an entity is able to reliably estimate the breakage amount, then it recognises the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer.

In relation to Kiki Co, it appears that the amount of breakage can be reliably determined and so this should be recognised in revenue as the gift card is redeemed. For every \$1 redeemed, Kiki Co should recognise \$1.43 ( $\$1 \times 100/70$ ) in revenue.

#### (ii) Royalty

According to IFRS 15, an entity should only account for revenue from a contract with a customer when it meets the following criteria:

- The contract has been approved;
- Rights regarding goods and services can be identified;
- Payment terms can be identified;
- It is probable the seller will collect the consideration it is entitled to.

At inception of the agreement, Kiki Co and Colour Co entered an explicit contract which specified payment terms and conditions. Moreover, Colour Co had a strong credit rating and so payment was probable. As such, it would seem that the above



criteria were met. IFRS 15 says that revenue from a usage-based royalty should be recognised as the usage occurs.

Whether a contract with a customer meets the above criteria is only reassessed if there is a significant change in facts and circumstances. In July 20X7, Colour Co lost major customers and sources of finance. As such, it was no longer probable that Kiki Co would collect the consideration it was entitled to. From July 20X7, no further revenue from the contract should be recognised.

According to IFRS 9 *Financial Instruments*, non-payment is an indicator that the outstanding receivables are credit impaired. A loss allowance should be recognised equivalent to the difference between the gross carrying amount of the receivables and the present value of the expected future cash flows receivable from Colour Co. Any increase or decrease in the loss allowance is charged to profit or loss.

**(b) Investment properties**

In accordance with IAS 40 *Investment Property*, the buildings should be initially measured at cost.

If the cost model is applied, then the buildings will be recognised at cost less accumulated depreciation and impairment losses.

If the fair value model is applied, then the buildings will be remeasured to fair value at each reporting date. Gains and losses on remeasurement are recognised in the statement of profit or loss. No depreciation is charged.

**Statement of financial position**

Assuming that property prices rise, the fair value model will lead to an increase in reported assets on the statement of financial position. In contrast, investment property measured using the cost model is depreciated, which reduces its carrying amount. This means that the fair value model may make Kiki Co appear more asset-rich. Some stakeholders may place importance on an entity's asset base, as it can be used as security for obtaining new finance. However, reporting higher assets can sometimes be perceived negatively. For example, asset turnover ratios will deteriorate, and so Kiki Co may appear less efficient.

If assets increase, then equity also increases. As such, the fair value model may lead to Kiki Co reporting a more optimistic gearing ratio. This may reduce the perception of risk, encouraging further investment.

**Statement of profit or loss**

In times of rising prices, the use of the fair value model will lead to gains being reported in the statement of profit or loss. This will increase profits for the period. In contrast, the depreciation charged under the cost model will reduce profits for the period. Therefore, earnings per share, a key stock market and investor ratio, is likely to be higher if the fair value model is adopted.

However, it should be noted that fair values are volatile. In some years, fair value gains may be much larger than in other years. If property prices decline, then the fair value model will result in losses. As such, reported profits are subject to more volatility if the fair value model is adopted. This may increase stakeholders' perception of risk. In contrast, the depreciation expense recorded in accordance with the cost model will be much more predictable, meaning that investors will be better able to predict Kiki Co's future results.

Many entities now present alternative performance measures (APMs), such as EBITDA (earnings before interest, tax, depreciation and amortisation). Other entities present 'underlying profit' indicators, which strip out the impact of non-operating or non-recurring gains or losses (such as the remeasurement of investment properties). Although the use of APMs has been criticised, Kiki Co may consider them to be useful in helping investors to assess underlying business performance through the eyes of management and to eliminate the impact of certain accounting policy choices.

**Statement of cash flows**

Accounting policy choices have no impact on the operating, investing or financing cash flows reported in the statement of cash flows.

## Disclosure

It should be noted that entities using the cost model for investment properties are required to disclose the fair value. Such disclosures enable better comparisons to be drawn between entities which account for investment property under different models.

## 38 Skizer

### Marking scheme

			Marks
(a)	(i)	Discussion of the Conceptual Framework and IAS 38 recognition criteria	6
	(ii)	Application of the following discussion to the scenario: 20X7 initial assessment of recognition criteria (met/not met), IAS 38 derecognition criteria and potential impairment assessment	2
		20X8 reclassification as R&D is not a change in estimate and impairment assessment	2
		If recognition criteria not met	1
	(iii)	Application of the following discussion to the scenario: Consideration of Skizer's business model	5
		The application of IFRS 15 to Skizer	2
			4
(b)	(i)	Discussion of IFRS 3 recognition of intangible assets and information provided about different intangible assets so that investor adjustments can be made	3
		Discussion of cost or revaluation under IAS 38 and differences	2
		Discussion of differences in treatment of R&D and development expenditure	2
			7
	(ii)	Discussion of measurement choices made in the financial statements	2
		Consideration of whether IR can supplement financial statements thereby providing more useful information for investors	1
			3
			25

- (a) (i) The *Conceptual Framework* defines an asset as a present economic resource **controlled** by the entity as a result of past events. An economic resource is a **right** that has the **potential** to produce economic benefits. Assets should be recognised if they meet the *Conceptual Framework* definition of an asset and such recognition provides users of financial statements with information that is useful (ie it is relevant and results in faithful representation). This is subject to the criteria that the benefits the information provides must be sufficient to justify the costs of providing that information. The wording of the recognition criteria in the *Conceptual Framework* allows for flexibility in how this criteria could be applied by the IASB in amending or developing IFRS Standards.

IAS 38 *Intangible Assets* defines an intangible asset as an identifiable non-monetary asset without physical substance. IAS 38 retains the 2010 *Conceptual Framework* definition of an asset which specifies that future economic benefits are **expected** to



flow to the entity. Furthermore IAS 38 requires an entity to recognise an intangible asset, if, and only if:

- (a) It is **probable** that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- (b) The cost of the asset can be measured reliably.

This requirement applies whether an intangible asset is acquired externally or generated internally. The probability of future economic benefits must be based on reasonable and supportable assumptions about conditions which will exist over the useful life of the asset. The probability recognition criterion is always considered to be satisfied for intangible assets which are acquired separately or in a business combination. If the recognition criteria are not met, IAS 38 requires the expenditure to be expensed when it is incurred.

The *Conceptual Framework* does not prescribe a 'probability criterion', and thus does not prohibit the recognition of assets or liabilities with a low probability of an inflow or outflow of economic benefits. In terms of intangible assets, it is arguable that recognising an intangible asset with a low probability of economic benefits would not be useful to users given that the asset has no physical substance.

The recognition criteria and definition of an asset in IAS 38 are **different** to those in the *Conceptual Framework*. The criteria in IAS 38 are more specific, but arguably do provide information that is relevant and a faithful representation. When viewed in this way, the requirements of IAS 38 in terms of recognition appear to be consistent with the *Conceptual Framework*.

- (ii) Skizer should have assessed whether the recognition criteria in IAS 38 were met at the time the entity capitalised the intangible assets. If the recognition criteria were met, then it was not appropriate to derecognise the intangible assets. According to IAS 38, an intangible asset should be derecognised only on disposal or when no future economic benefits are expected from its use or disposal. If there were any doubts regarding the recoverability of the intangible asset, then Skizer should have assessed whether the intangible assets would be impaired. IAS 36 *Impairment of Assets* would be used to determine whether an intangible asset is impaired.

Further, the reclassification of intangible assets to research and development costs does not constitute a change in an accounting estimate. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that a change in accounting estimate is an adjustment of the carrying amount of an asset or liability, or related expense, resulting from reassessing the expected future benefits and obligations associated with that asset or liability. However, if Skizer concludes that the intangible assets' carrying amounts exceed their recoverable amounts, an impairment loss should be recognised. The costs of the stakes in the development projects can be determined and will not have been estimated.

If the recognition criteria were not met, then Skizer would have to recognise retrospectively a correction of an error, in accordance with IAS 8.

- (iii) Gains arising from the derecognition of an intangible asset cannot be presented as revenue as IAS 38 explicitly forbids it. There is no indication that Skizer's business model is to sell development projects but, rather, it undertakes the development of new products in conjunction with third party entities. Skizer's business model is to jointly develop a product, then leave the production to partners. As Skizer has recognised an intangible asset in accordance with IAS 38, and fully impaired the asset, it cannot argue that it has thereafter been held for sale in the ordinary course of business. Therefore, according to IAS 38, the gain from the derecognition of the intangible asset cannot be classified as revenue under IFRS 15 *Revenue from Contracts with Customers* but as a profit on the sale of the intangible asset.
- (b) (i) Under IFRS 3 *Business Combinations*, acquired intangible assets must be recognised and measured at fair value if they are separable or arise from other contractual rights, irrespective of whether the acquiree had recognised the assets prior to the



business combination occurring. This is because there should always be sufficient information to reliably measure the fair value of these assets. IFRS 3 requires all intangible assets acquired in a business combination to be treated in the same way in line with the requirements of IAS 38. IAS 38 requires intangible assets with finite lives to be amortised over their useful lives and intangible assets with indefinite lives to be subject to an annual impairment review in accordance with IAS 36.

However, it is unlikely that all intangible assets acquired in a business combination will be homogeneous and investors may feel that there are different types of intangible assets which may be acquired. For example, a patent may only last for a finite period of time and may be thought as having an identifiable future revenue stream. In this case, amortisation of the patent would be logical. However, there are other intangible assets which are gradually replaced by the purchasing entity's own intangible assets, for example, customer lists, and it may make sense to account for these assets within goodwill. In such cases, investors may wish to reverse amortisation charges. In order to decide whether an amortisation charge makes sense, investors require greater detail about the nature of the identified intangible assets. IFRSs do not permit a different accounting treatment for this distinction.

IAS 38 requires an entity to choose either the cost model or the revaluation model for each class of intangible asset. Under the cost model, after initial recognition intangible assets should be carried at cost less accumulated amortisation and impairment losses. Under the revaluation model, intangible assets may be carried at a revalued amount, based on fair value, less any subsequent amortisation and impairment losses only if fair value can be determined by reference to an active market. Such active markets are not common for intangible assets. If an intangible asset is reported using the cost model, the reported figures for intangible assets such as trademarks may be understated when compared to their fair values. Based upon the principle above regarding the different types of intangible asset, it would make sense for different accounting treatments subsequent to initial recognition. Some intangible assets should be amortised over their useful lives but other intangible assets should be subject to an annual impairment review, in the same way as goodwill.

IAS 38 requires all research costs to be expensed with development costs being capitalised only after the technical and commercial feasibility of the asset for sale or use has been established. If an entity cannot distinguish the research phase of an internal project to create an intangible asset from the development phase, the entity treats the expenditure for that project as if it were incurred in the research phase only. There is some logic to the capitalisation of development expenditure as internally generated intangible assets but the problem for investors is disclosure in this area as companies do not have a consistent approach to capitalisation. It is often unclear from disclosures how the accounting policy in respect of research and development was applied and especially how research was distinguished from development expenditure. One of the issues is that the disclosure of relevant information is already contained within IFRSs but preparers are failing to comply with these requirements or the disclosure is insufficient.

Intangible asset disclosure can help analysts answer questions about the innovation capacity of companies and investors can use the disclosure to identify companies with intangible assets for development and commercialisation purposes.

- (ii) Measuring the contribution of intangible assets to future cash flows is fundamental to integrated reporting and will help explain the gaps between the carrying amount, intrinsic and market equity value of an entity. As set out above, organisations are required to recognise intangible assets acquired in a business combination. Consequently, the intangible assets are only measured once for this purpose. However, organisations are likely to go further in their integrated report and disclose the change in value of an intangible asset as a result of any sustainable growth strategy or a specific initiative. It is therefore very useful to communicate the value of intangible assets in an integrated report. For example, an entity may decide to



disclose its assessment of the increase in brand value as a result of a corporate social responsibility initiative.

## 39 Toobasco

### Marking scheme

		Marks
(a)	Discussion of the comparability of APMs	1
	Application of the following discussion to the scenario:	
	Extraordinary items	2
	Free cash flow and its description	2
	EBITDAR	4
	Tax effects	1
		<u>10</u>
(b)	(i) Adjustment of net cash generated from operating activities	4
	(ii) Reconciliation to free cash flow	4
	(iii) Application of the following discussion to the scenario:	
	Purchase and sale of cars	1
	Purchase of associate	1
	Foreign exchange losses	1
	Pension payments	1
	Interest paid	1
		<u>5</u>
	Professional marks	2
		<u>25</u>

- (a) (i) APMs are not defined by IFRS Standards and therefore may not be directly comparable with other companies' APMs, including those in the group's industry. Where the same category of material items recurs each year and in similar amounts (in this example, restructuring costs and impairment losses), the entity should consider whether such amounts should be included as part of underlying profit.
- Under IFRS Standards, items cannot be presented as 'extraordinary items' in the financial statements or in the notes. Thus, it may be confusing to users of the APMs to see this term used. It is not appropriate to state that a charge or gain is non-recurring unless it meets the criteria. Items such as restructuring costs or impairment losses should not be labelled as non-recurring where it is misleading. However, the entity can make an adjustment for a charge or gain which they believe is appropriate, but they cannot describe such adjustments inaccurately.
- (ii) The deduction of capital expenditures, purchase of own shares and the purchase of intangible assets from the IAS 7 measure of cash flows from operating activities is acceptable as free cash flow does not have a uniform definition. As a result, a clear description and reconciliation showing how this measure is calculated should be disclosed. Entities should also avoid misleading inferences about its usefulness. Free cash flow does not normally represent the residual cash flow available as many entities have mandatory debt service requirements which are not normally deducted from the measure. It would also be misleading to show free cash flow per share in bold alongside earnings per share as they are not comparable.
- (iii) When an entity presents an APM, it should present the most directly comparable measure which has been calculated in accordance with IFRS Standards with equal or greater prominence. The level of prominence would depend on the facts and circumstances. In this case, the entity has omitted comparable information from an earnings release which includes APMs such as EBITDAR. Additionally, the entity has emphasised the APM measure by describing it as 'record performance' without an

equally prominent description of the measure calculated in accordance with IFRS Standards. Further, the entity has provided a discussion of the APM without a similar discussion and analysis of the same information presented from an IFRS Standards perspective.

The entity has presented EBITDAR as a performance measure; such measures should be reconciled to profit for the year as presented in the statement of comprehensive income. Operating profit would not be considered the best starting point as EBITDAR makes adjustments for items which are not included in operating profit such as interest and tax.

The entity has changed the way it calculates the APM because it has treated rent differently. However, if an entity chooses to change an APM, the change and the reason for the change should be explained and any comparatives restated. A change would be appropriate only in exceptional circumstances where the new APM better achieves the same objectives, perhaps if there has been a change in the strategy. The revised APM should be reliable and more relevant.

- (iv) The entity should provide income tax effects on its APMs depending on the nature of the measures. The entity should include current and deferred income tax expense commensurate with the APM and the APM should not be presented net of tax as income taxes should be shown as a separate adjustment and explained.
- (b) (i) *Adjustment of net cash generated from operating activities for errors in the statement*

	\$m
Net cash generated from operating activities per question	278
Add cash inflows relating to the disposal of cars	30
Effect of changes in foreign exchange rates	28
Reclassification of interest paid	18
Tax credit not recorded	<u>6</u>
	360
Less	
Associate's profit – incorrectly included	(12)
Associate's profit – non-cash flow	<u>(4)</u>
Net cash generated from operating activities	<u>344</u>

- (ii) *Free cash flow reconciliation*

	\$m
Net cash generated from operating activities	344
Net capital expenditure	(46)
Purchase of associate	(20)
Dividend received from associate	1
Interest received	10
Interest paid	(18)
Pension deficit payments	<u>27</u>
Free cash flow	<u>298</u>

- (iii) *Purchase and sale of cars*

Toobasco's presentation of cash flows from the sale of cars as being from investing activities is incorrect as cash flows from the sale of cars should have been presented as cash flows from operating activities (\$30 million). IAS 16 *Property, Plant and Equipment* (PPE) states that an entity which normally sells items of PPE which are held for rental to others should transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. Subsequent proceeds from the sale of such assets should be recognised as revenue in accordance with IFRS 15 *Revenue from Contracts with Customers* and thus shown as cash flows from operating activities.



#### Purchase of associate

	\$m
Balance at 31 August 20X8	23
Less profit for period \$16m × 25%	(4)
Add dividend received \$4m × 25%	<u>1</u>
Cost of acquisition (cash)	<u>20</u>

Therefore, cash paid for the investment is \$20 million, and cash received from the dividend is \$1 million.

In order to arrive at the correct figure for net cash generated from operating activities, the incorrect treatment of the profit for the year for the associate must be eliminated (\$12 million) and the correct adjustment of \$4 million shown in net cash generated by operating activities.

#### Foreign exchange losses

IAS 7 *Statement of Cash Flows* states that unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. The amounts reported in the statement of cash flows included, in error, the effect of changes in foreign exchange rates arising on the retranslation of its overseas operations. As a consequence, cash generated from operating activities should be increased by \$28 million. All exchange differences relating to the subsidiary are taken to a separate component of equity, until disposal of the foreign operation when they are recycled to the statement of profit or loss.

#### Pension payments

The pension payments are correctly included in operating cash flows. However, they are excluded when calculating free cash flow. As the tax cash benefit has not been included, net cash generated from operating activities will be adjusted for the \$6 million and \$27 million (\$33m – \$6m) will be excluded from the free cash flow calculation.

#### Interest paid

Interest paid which is capitalised into the cost of property, plant, and equipment should be treated as cash flows arising from investing activities whereas interest paid and capitalised into inventory should be classified in the operating section of the statement of cash flows. Thus, there should be a reclassification of interest paid of \$18 million from the operating section to the investing activities section.

## 40 Holls

### Marking scheme

		Marks
(a)	(i) Arguments for and against the non-binding framework	4
	(ii) • A discussion of understandability, relevance and comparability	3
	• Application of the above characteristics to management commentary	<u>2</u>
		5

		Marks
(b)	An explanation of why taxable profits are different from accounting profit	2
	Application of the following explanations to the scenario:	
	• Tax reconciliation	4
	• Tax rates	3
	• Deferred taxation	<u>5</u>
		14
		<u>2</u>
		<u>25</u>

- (a) (i) The IFRS Practice Statement *Management Commentary* provides a broad, non-binding framework for the presentation of management commentary. The Practice Statement is not an IFRS. Consequently, entities applying IFRS Standards are not required to comply with the Practice Statement, unless specifically required by their jurisdiction. Furthermore, non-compliance with the Practice Statement will not prevent an entity's financial statements from complying with IFRS Standards.
- It can be argued that the International Accounting Standards Board's objectives of enhancing consistency and comparability may not be achieved if the framework is not mandatory. A standard is more likely to guarantee a consistent application of the principles and practices behind the management commentary (MC).
- However, it is difficult to create a standard on the MC which is sufficiently detailed to cover the business models of every entity or be consistent with all IFRS Standards. Some jurisdictions take little notice of non-mandatory guidance but the Practice Statement provides regulators with a framework to develop more authoritative requirements.
- The Practice Statement allows companies to adapt the information provided to particular aspects of their business. This flexible approach could help generate more meaningful disclosures about resources, risks and relationships which can affect an entity's value and how these resources are managed. It provides management with an opportunity to add context to the published financial information, and to explain their future strategy and objectives without being restricted by the constraints of a standard.
- If the MC were a full IFRS Standard, the integration of management commentaries and the information produced in accordance with IFRS Standards could be challenged on technical grounds, as well as its practical merits. In addition, there could be jurisdictional concerns that any form of integration might not be accepted by local regulators.
- (ii) The *Conceptual Framework* states that 'an essential quality of the information provided in financial statements is that it is readily understandable by users'. The MC should be written in plain language and a style appropriate to users' needs. The primary users of management commentary are those identified in the *Conceptual Framework*. The form and content of the MC will vary between entities, reflecting the nature of their business, the strategies adopted and the regulatory environment in which they operate. Users should be able to locate information relevant to their needs.
- Information has the quality of relevance when it has the capacity to influence the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. Relevant financial information is capable of making a difference to the decision made by users. In order to make a difference, financial information has predictive value, confirmatory value or both. The onus is on management to determine what information is important enough to be included in the MC to enable users to 'understand' the financial statements and meet the objective of the MC. If the entity provides too much information, it could



reduce its relevance and understandability. If material events or uncertainties are not disclosed, then users may have insufficient information to meet their needs.

However, unnecessary detail may obscure important information especially if entities adopt a boiler-plate approach. If management presents too much information about, for example, all the risks facing an organisation, this will conflict with the relevance objective. There is no single optimal number of disclosures but it is useful to convey their relative importance in a meaningful way.

Comparability is the qualitative characteristic which enables users to identify and understand similarities and differences amongst items. It is important for users to be able to compare information over time and between entities. Comparability between entities is problematic as the MC is designed to reflect the perspectives of management and the circumstances of individual entities. Thus, entities in the same industry may have different perceptions of what is important and how they measure and report it. There are some precedents on how to define and calculate non-financial measures and financial measures which are not produced in accordance with IFRSs but there are inconsistencies in the definition and calculation of these measures.

It is sometimes suggested that the effectiveness of the overall report may be enhanced by strengthening the links between financial statements and the MC. However, such suggestions raise concerns about maintaining a clear distinction between the financial statement information and other information.

An entity should ensure consistency in terms of wording, definitions, segment disclosures, etc between the financial statements and the MC to improve the understanding of financial performance.

- (b) Current tax is based on taxable profit for the year. Taxable profit is different from accounting profit due to temporary differences between accounting and tax treatments, and due to items which are never taxable or tax deductible. Tax benefits such as tax credits are not recognised unless it is probable that the tax positions are sustainable.

The Group is required to estimate the corporate tax in each of the many jurisdictions in which it operates. The Group is subject to tax audits in many jurisdictions; as a result, the Group may be required to make an adjustment in a subsequent period which could have a material impact on the Group's profit for the year.

### **Tax reconciliation**

The tax rate reconciliation is important for understanding the tax charge reported in the financial statements and why the effective tax rate differs from the statutory rate.

Most companies will reconcile the group's annual tax expense to the statutory rate in the country in which the parent is based. Hence the rate of 22% is used in the tax reconciliation. It is important that the reconciliation explains the reasons for the differences between the effective rate and the statutory rate. There should be minimal use of the 'other' category. In this case, the other category is quite significant (\$14 million) and there is no explanation of what 'other' constitutes.

One-off and unusual items can have a significant effect on the effective tax rate, but financial statements and notes often do not include a detailed discussion of them. For example, the brand impairment and disposals of businesses should be explained to investors, as they are probably material items. The explanation should include any potential reversal of the treatment.

Some profits recognised in the financial statements are non-taxable such as the tax relating to non-taxable gains on disposals of businesses and in some jurisdictions, taxation relief on impairment losses will not be allowable for taxation. The reasons for these items not being allowed for taxation should be explained to investors.



## Tax rates

As the Group is operating in multiple countries, the actual tax rates applicable to profits in those countries are different from the local tax rate. The overseas tax rates are higher than local rates, hence the increase in the taxation charge of \$10 million. The local rate is different from the weighted average tax rate (27%) of the Group based on the different jurisdictions in which it operates. Investors may feel that using the weighted tax rate in the reconciliation gives a more meaningful number because it is a better estimate of the tax rate the Group expects to pay over the long term. Investors will wish to understand the company's expected long-term sustainable tax rate so they can prepare their cash flow or profit forecasts.

Information about the sustainability of the tax rate over the long term is more important than whether the rate is high or low compared to other jurisdictions. An adjustment can be made to an investor's financial model for a long-term sustainable rate, but not for a volatile rate where there is no certainty over future performance. For modelling purposes, an understanding of the actual cash taxes paid is critical and the cash paid of \$95 million can be found in the statement of cash flows.

## Deferred taxation

Provision for deferred tax is made for temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and their value for tax purposes. The amount of deferred tax reflects the expected recoverable amount and is based on the expected manner of recovery or settlement of the carrying amount of assets and liabilities, using the basis of taxation enacted or substantively enacted by the financial statement date.

Deferred tax assets are not recognised where it is more likely than not that the assets will not be realised in the future and reference to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is useful in this regard. The evaluation of deferred tax assets' recoverability requires judgements to be made regarding the availability of future taxable income.

Management assesses the available evidence to estimate if sufficient future taxable income will be generated to use the existing deferred tax assets. A significant piece of objective negative evidence evaluated was the loss incurred in the period prior to the period ended 30 November 20X7. Such objective evidence may limit the ability to consider other subjective evidence such as projections for future growth. Deferred taxes are one of the most difficult areas of the financial statements for investors to understand. Thus, there is a need for a clear explanation of the deferred tax balances and an analysis of the expected timing of reversals. This would help investors see the time period over which deferred tax assets arising from losses might reverse. It would be helpful if the company provided a breakdown of which reversals would have a cash tax impact and which would not.

As the proposed tax law was approved, it is considered to be enacted. Therefore, the rate of 25% should be used to calculate the deferred tax liability associated with the relevant items which affect deferred taxation.

At 30 November 20X7, Holls has deductible temporary differences of \$4.5 million which are expected to reverse in the next year. In addition, Holls also has taxable temporary differences of \$5 million which relate to the same taxable company and the tax authority. Holls expects \$3 million of those taxable temporary differences to reverse in 20X8 and the remaining \$2 million to reverse in 20X9. Thus a deferred tax liability of \$1.25 million ( $\$5 \text{ million} \times 25\%$ ) should be recognised and as \$3 million of these taxable temporary differences are expected to reverse in the year in which the deductible temporary differences reverse, Holls can also recognise a deferred tax asset for \$0.75 million ( $\$3 \text{ million} \times 25\%$ ). The recognition of a deferred tax asset for the rest of the deductible temporary differences will depend on whether future taxable profits sufficient to cover the reversal of this deductible temporary difference are expected to arise. Deferred tax assets and liabilities must be recognised gross in the statement of financial position. However, it may be possible to offset the deferred tax assets and the deferred tax liabilities if there is a legally enforceable right to offset the current income tax assets against current income tax



liabilities as the amounts relate to income tax levied by the same taxation authority on the same taxable entity.

After the enactment of a new tax law, when material, Hols should consider disclosing the anticipated current and future impact on their results of operations, financial position, liquidity, and capital resources. In addition, Hols should consider disclosures in the critical accounting estimates section of the management commentary to the extent the changes could materially affect existing assumptions used in making estimates of tax-related balances. Changes in tax laws and rates may affect recorded deferred tax assets and liabilities and the effective tax rate in the future.

## 41 Crypto

**Workbook references.** IFRS 16 *Leases* is covered in Chapter 9. IFRS 10 is covered in Chapter 11, and IFRS 11 is covered in Chapter 15. IFRS 9 *Financial Instruments* is covered in Chapter 8.

**Top tips.** There are two professional marks available in this question for clarity and quality of the discussion in part (b). This will be the case for one question in section B of every exam - two professional marks will be available in the question that requires analysis from the perspective of a stakeholder.

Part (a)(i) required advice on the treatment of an investment. The examiner's report stated that many answers to this question were weak - with many candidates focusing on only on IFRS 11, rather than first looking at the issue of control under IFRS 10. Part (a)(ii) was extremely challenging and required advice on the treatment of an embedded derivative contract which was then modified into an executory contract.

Part (b)(i) required a discussion on the key changes from an investor perspective of the application of the lessee accounting requirements in IFRS 16. Remember in this part of your answer to consider the investor and not just state the accounting adjustments required. Part (b)(ii) required a discussion on how IFRS 16 would impact on three accounting ratios and more generally from the financial statements now that previously reported 'off-balance sheet' leases are now on-balance sheet. Ensure you link the effect on each ratio to the change in accounting treatment required under IFRS 16.

### Marking scheme

			Marks
(a)	(i)	Discussion of the following accounting issues and application to the scenario:	
		• The definition of control per IFRS 10 and joint control per IFRS 11	3
		• Power over the investee	3
			6
	(ii)	Discussion of the following accounting issues and application to the scenario:	
		• IFRS 9 requirements for embedded derivatives and hybrid	3
		• IFRS 9 requirements for contract modifications	2
			5
(b)	(i)	Discussion of the IFRS 16 requirements Implications for investors	3 3
			6
	(ii)	Description of the IFRS 16 impact on accounting numbers Impact on the following ratios:	2
		• Interest cover	2
		• ROCE	1
		• Debt to EBITDA	1
			6
		Professional marks	2
			25



- (a) (i) Before assessing whether an entity has joint control over an arrangement, an entity must first assess whether the parties control the arrangement in accordance with the definition of control in IFRS 10 *Consolidated Financial Statements*. If not, an entity must determine whether it has joint control of the arrangement. IFRS 11 *Joint Arrangements* defines joint control as '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 means an assessment as to whether any party can prevent any of the other parties from making unilateral decisions without its consent. It must be clear which combination of parties is required to agree unanimously to decisions about the relevant activities of the arrangement. In the case of Kurran Co, there is more than one combination of parties possible to reach the required majority. As a result, Crypto Co does not have joint control.

In addition to the above, Crypto Co does not control Kurran Co because IFRS 10 states that control requires power over the investee which gives the investor the ability to direct the relevant activities. Crypto Co does not have the ability to direct the relevant activities as it can only block decisions and cannot make decisions by itself. Also, there is no shareholder agreement which sets out shareholders' voting rights and obligations and thus the other shareholders can act together to prevent Crypto Co from making decisions in its own interest. Crypto Co does not have joint control as agreement between itself and other board members has to occur for a decision to be made. Therefore, it appears that Kurran Co is an associate of Crypto Co and would apply IAS 28 *Investments in Associates and Joint Ventures*.

- (ii) IFRS 9 *Financial Instruments* states that 'any embedded derivative included in a contract for the sale or purchase of a non-financial item that is denominated in a foreign currency shall be separated when its economic characteristics and risks are not closely related to those of the host contract'. Thus, in contrast to the treatment for hybrid contracts with financial asset hosts, derivatives embedded with a financial liability will often be separately accounted for. That is, they must be separated if they are not closely related to the host contract, they meet the definition of a derivative, and the hybrid contract is not measured at fair value through profit or loss (FVTPL).

The contract is a hybrid contract containing a host contract which is an executory contract to purchase electricity at a price of 20 million euros and a non-closely related embedded foreign currency derivative with an initial fair value of zero to buy 20 million euros, sell 25 million dollars. However, the derivative should have been valued at FVTPL and not fair value through other comprehensive income.

At the date of the modification of the contract to the functional currency of Crypto Co, there is a significant change to the contract which will trigger a reassessment of its position under IFRS 9. As the contract no longer has a non-closely related embedded derivative, the entire arrangement will be accounted for prospectively as an executory contract which is outside the scope of IFRS 9. The embedded derivative will be derecognised and it is likely that Crypto Co will have to pay the counterparty 2 million euros in compensation.

- (b) (i) IFRS 16 *Leases* introduces a single lessee accounting model and should reduce the number of off-balance sheet leases. Upon lease commencement, a lessee recognises a right-of-use asset and a lease liability. After lease commencement, a lessee measures the right-of-use asset using a cost model less accumulated depreciation and accumulated impairment. The lease liability is initially measured at the present value of the lease payments payable over the lease term, discounted at the rate implicit in the lease if that can be readily determined. Lease liabilities include only economically unavoidable payments.

Investors should bear in mind that some sectors and some companies will be more affected than others. As a result, companies with previous material off-balance sheet leases will report higher assets and financial liabilities. The standard will reduce complexity in financial statements as it should allow comparisons to be made between those companies who lease assets and those who borrow to buy assets.



Investors will no longer have to estimate the assets and liabilities resulting from off-balance sheet leases when calculating ratios as there should be fewer off-balance sheet leases. IFRS 16 will result in more information about leases both on the statement of financial position and in the notes and will provide a more accurate reflection of the economics of leases. The carrying amount of lease assets will typically reduce more quickly than the carrying amount of lease liabilities. This will result in a reduction in reported equity for companies with previous material off-balance sheet leases.

IFRS 16 requires a lessee to disclose lease liabilities separately from other liabilities as a separate line item, or together with other similar liabilities, in a manner which is relevant to understanding the lessee's financial position. A lessee will also split lease liabilities into current and non-current portions, based on the timing of payments.

- (ii) The recognition of an asset which was previously unrecognised will result in a higher asset base, which will affect ratios such as asset turnover. The recognition of a liability which was previously unrecognised will result in higher financial liabilities, which will affect gearing. The recognition of depreciation and interest instead of operating lease expense will result in higher operating profit because interest is typically excluded from operating expenses and will affect performance ratios. Similarly, profit measures which exclude interest and depreciation but previously included operating lease expense, such as EBITDA, will be higher under IFRS 16.

Interest cover: there will be an increase in the earnings measure (ie EBITDA) which will not be proportionate to the increase in interest. The change in the ratio will depend on the characteristics of the lease portfolio.

Return on capital employed: it is likely that ROCE will be lower under IFRS 16 because the increase in operating profit is unlikely to be proportionate to the increase in capital employed.

Debt to EBITDA: ratio of debt to EBITDA is likely to be higher because debt will increase by more than the increase in earnings. Debt will increase because of the fact that lease liabilities will be recognised on the statement of financial position. For companies which have material off-balance sheet leases, IFRS 16 is expected to result in higher profit before interest because a company presents the implicit interest in lease payments for former off-balance sheet leases as part of finance costs. Previously, the entire expense related to off-balance sheet leases was included as part of operating expenses. The size of the increase in operating profit, and finance costs, will depend on the significance of leasing activities to the company.

## 42 Guidance

**Workbook references.** The *Conceptual Framework* is covered in Chapter 1. Analysis is covered in Chapter 18. IFRS 10 *Consolidated Financial Statements* is covered in Chapter 11.

**Top tips.** There are two professional marks available in this question for clarity and quality of the discussion in part (b). This will be the case for one question in section B of every exam – two professional marks will be available in the question that requires analysis from the perspective of a stakeholder.

Part (a) required a discussion of why a reporting entity may choose a particular accounting policy where IFRS allows a choice, and the impact of faithful representation and comparability on the choice. You need to know that faithful representation and comparability are qualitative characteristics of useful information, as described in the *Conceptual Framework*. The *Conceptual Framework* is fundamental to SBR, you must make sure you are familiar with it.

Part (b)(i) required calculation of return on equity ratio (ROE) and discussion on the usefulness to investors of that ratio and its component parts. The examiner commented that some candidates didn't include discussion of the component parts of ROE, despite this being clearly stated in the requirement – make sure you read requirements carefully and ensure you answer each part of each requirement.



Part (b)(ii) asked for a discussion of the impact of the accounting transactions in the scenario on the ROE ratio (and its components), and a recalculation of a more comparable ROE between the two years. The examiner commented 'better answers included a description of the impact on each component as well as the ROE (meeting the question's whole requirement) and provided a table in which the original accounting data is adjusted for each transaction'. Remember that laying out your answers clearly helps the marker to see what you have done, enabling them to award you marks more easily.

### Marking scheme

			Marks
(a)	Discussion of the issues relating to accounting choice	3	
	Discussion of whether faithful representation and comparability are affected	<u>3</u>	6
(b)	(i) Discussion of the meaning of the return on equity (ROE) and its component parts	3	
	Calculation of ROE for the years ended 31 December 20X5 and 20X6	<u>2</u>	5
	(ii) Application of the following discussion to the scenario:		
	• Transfer of property to SPE	2	
	• Buy back of shares	2	
	• Raising loan capital	2	
	• Purchase of associate	2	
	• Calculation of the impact on ROE and its component parts	<u>4</u>	
			12
	Professional marks	<u>2</u>	
		<u>25</u>	

- (a) Where an IFRS Standard allows an entity an accounting choice, then the financial statements will be influenced and affected by that choice. Management's intent and motivation will influence accounting information. The accounting policy chosen can be driven by self-interest, by a wish to maximise the interests of shareholders, or by a wish to provide information. Where there is flexibility when applying the IFRS Standard, the financial statements can become less comparable. Entities may use the financial choices to increase earnings, and manipulate accounting figures in order to influence contractual outcomes which depend on the accounting figures reported.

Accounting choices exist to provide companies which operate under different business models with the option of utilising an accounting method which best represents their operations. Any accounting choice in IFRS Standards should still result in the financial statements being faithfully represented. A faithful representation means that to the maximum extent possible, the financial statements are complete, neutral and free from error. A faithful representation is affected by the level of measurement uncertainty in the financial statements.

Comparability is one of the four qualitative characteristics which enhances the usefulness of information. Thus, accounting information would be more useful if it can be compared with similar information from other entities, or from the same entity.

However, it is extremely difficult for entities to have 'comparable' financial information. Comparability is crucial to improve financial reporting quality but it can be argued that comparability is made more difficult by the fact that the Board allows entities to choose between alternative measurement bases. Environmental, economic, political, cultural, operational differences could be solved with the existence of accounting choices in the standards, but these choices could be at the cost of comparability, especially if there are



internal or external factors influencing the reliable disclosure of an item. A faithful representation might lead to comparability, because it should reflect the characteristics of the asset or liability.

- (b) (i) The return on equity (ROE) ratio measures the rate of return which the owners of issued shares of a company receive on their shareholdings in terms of profitability. ROE signifies how good the company is in generating profit on the investment it receives from its shareholders. This metric is especially important from an investor's perspective, as it can be used to judge how efficiently the firm will be able to use shareholder's investment to generate additional revenues.

The net profit margin (net profit/sales) tells how much profit a company makes on every dollar of sales. Asset turnover (sales/assets) ratio measures the value of a company's sales or revenues generated relative to the carrying amount of its assets. The asset turnover ratio can often be used as an indicator of the efficiency with which a company is deploying its assets in generating revenue. The equity ratio indicates the relative proportion that equity is used to finance a company's assets. The equity ratio is a good indicator of the level of leverage used by a company by measuring the proportion of the total assets which are financed by shareholders, as opposed to creditors.

	20X5	20X6
Net profit margin	15%	17.3%
Asset turnover	0.8	1.05
Equity ratio	1.43	2.1
Return on equity	17%	38%

(ii) **Setting up of special purpose entity (SPE)**

IFRS 10 *Consolidated Financial Statements* states that an investor controls a SPE when it is exposed, or has rights, to variable returns from its involvement with the SPE and has the ability to affect those returns through its power over the SPE. This revised definition of control focuses on the need to have both power and variable returns before control is present. Power is the current ability to direct the activities which significantly influence returns. Guidance Co obtains the rewards from the assets transferred and is exposed to the risks. By transferring their assets to a SPE, the asset turnover ratio will be significantly larger. However, the SPE should be consolidated by Guidance Co in its group financial statements and the property included in assets and the charge eliminated from revaluation reserves in its single entity financial statements. The latter will increase shareholder equity.

**Miscellaneous transactions**

A major concern about using ROE is when a company buys back its shares, it decreases the equity on the statement of financial position and in the case of Guidance Co, its cash and consequently its total assets. As a result, the performance metrics – asset turnover and ROE – will be affected. The ROE figure could produce a misleading indicator as to how well a company is being managed. As the equity portion of ROE shrinks, the ROE metric gets larger. The ROE calculation can become meaningless if a company regularly buys back its shares and thus as a result there may be better metrics for investors to use such as the P/E ratio.

Guidance Co has raised loan capital of \$20 million during the period and this amount will not be included in the ROE calculations because ROE is based on assets as opposed to net assets. One company may have a higher ROE than another company simply because it finances the business through loan capital rather than raising equity capital. It can be argued that ROE is not a meaningful measure of performance, as it takes no account of the amount of debt involved in creating profits.

Therefore, return on capital employed may be a better current measure for Guidance Co.

Guidance Co has included the profit from the purchase of an associate in the current year's figures. If the share of the results of the associate were excluded, this would allow Guidance Co's profitability to result exclusively from Guidance Co's asset base. It could be argued that the full value of the company's reported profit including the associate could distort the analysis of Guidance Co's performance as compared to the last financial year.

There is no need to adjust for the original \$15 million investment in the associate because one asset is merely being replaced by another but the total assets remain the same.

#### Adjusted amounts

		SPE property \$m	Shares cancelled \$m	Associate \$m	Total \$m
Profit before tax	38			(4)	34
Sales	220		220		
Assets	210	50	30	290	
Equity	100	50	30	(4)	176

#### Adjusted calculations

	20X5	20X6 (adjusted)	20X6 (unadjusted)
Net profit margin	15%	15.5%	17.3%
Asset turnover	0.8	0.76	1.05
Equity ratio	1.43	1.65	2.1
ROE	17%	19.3%	38%

It can be seen that if the impact of the transactions in the period were eliminated, then there has been a significant reduction in ROE and its component parts. The buyback of shares and the purchase of the associate were legitimate transactions but they were eliminated in order to determine comparative metrics. The raising of the loan capital was also legitimate but was not adjusted for because ROE is based on assets, not net assets. The transfer of assets to a SPE was contrary to IFRS 10 and would have been reversed in any event. Although financial metrics are intended to enable comparisons between companies, the relative performance of any particular company can be affected by transactions both acceptable and unacceptable under accounting standards.

## 43 Handfood Co

### Marking scheme

			Marks
(a)	(i)	Discussion of the <i>IFRS for SMEs</i> Standard: Simplifications and omissions	2
		Disclosure	1
		Recognised concepts	<u>1</u>
			4
	(ii)	Discussion of: Information asymmetry issues and investors knowledge	4
	(iii)	Discussion of Integrated Reporting: Better understanding	2
		Better communication	1
		Nature of IR	<u>2</u>
			5



			Marks
(b)	(i)	Discussion of principles of accounting for additional benefit liability/current service cost	4
		Calculation of current service cost 20X2	<u>2</u>
	(ii)	Discussion of effect of change in assumptions	6
		Professional marks	4
			<u>2</u>
			<u>25</u>

- (a) (i) The principal aim when developing the *IFRS for SMEs* Standard was to provide a framework that generated relevant, reliable and useful information and the provision of a high quality and understandable accounting standard suitable for SMEs. The SMEs Standard itself is self-contained, and incorporates accounting principles based on IFRS Standards. It comprises a single standard divided into simplified sections for each relevant IFRS Standard but which have also omitted certain IFRS Standards such as earnings per share and segmental reporting. In addition, there are certain accounting treatments that are not allowable under the SMEs Standard. For example, there is no separate guidance for non-current assets held for sale.

To this end, the SMEs Standard makes numerous simplifications to the recognition, measurement and disclosure requirements in full IFRS Standards. Examples of these simplifications are:

- Intangible assets must be amortised over their useful lives. If the useful life is not determinable then it is presumed to be 10 years.
- The cost model (investment is measured at cost less any accumulated impairment losses) can be used for investments in associates. This model may not be used for investments for which there is a published price quotation, in which case the fair value model must be applied.

The disclosure requirements in the SMEs Standard are also substantially reduced when compared with those in full IFRS Standards partly because they are not considered appropriate for users' needs and for cost-benefit considerations. Many disclosures in full IFRS Standards are more relevant to investment decisions in capital markets than to the transactions undertaken by SMEs. The SMEs Standard is naturally a modified version of full IFRS Standards, and not an independently developed standard. It is based on recognised concepts and pervasive principles and it will allow easier transition to full IFRS Standards if the SME decides to become a public listed entity.

- (ii) The SMEs Standard decreases information asymmetry between the firm and the users, because of its recognition, measurement and disclosure requirements. However, there are certain facts and information in companies which is not disclosed by them to investors under any accounting standards. SMEs have access to all relevant information, while investors lack much of the relevant information. Unfortunately, lack of relevant information will have an adverse effect on the decision-making of the investor. Information related to the SME's credit, project risk and benefits are known more by the SME than by the investor giving the SME an information advantage. Therefore, investors are in a relatively disadvantaged position, and if they, for example, are financial institutions, they will raise lending rates to reduce potential risk of credit losses or may not invest at all. The more incomplete and the less transparent the information from the SME, the higher will be the risk related to the investment and the higher will be the return that the investor requires. The access to investment by SMEs could be determined by the quality of financial statements, information asymmetry and perceived risk. Quality financial statements reduce the level of information asymmetry which reduces perceived risk.



- (iii) Integrated reporting could help SMEs better understand and better communicate how they create value. It can provide a roadmap for SMEs to consider the multiple capitals that make up its value creation. An integrated report represents a more complete corporate report which will help SMEs understand their business so they can implement a business model that will help them grow. SMEs use a range of resources and relationships to create value. An integrated reporting approach helps SMEs build a better understanding of the factors that determine its ability to create value over time. Integrated thinking helps SMEs gain a deeper understanding of the mechanics of their business. This will help them assess the strengths of their business model and spot any deficiencies. These will create a forward-looking approach and sound strategic decision making.

Some SMEs have few tangible assets and operate in a virtual world. As such, conventional accounting will fail to provide a complete picture as to its ability to create value. Capitals, such as employee expertise, customer loyalty, and intellectual property, will not be accounted for in the financial statements which are only one aspect of an SME's value creation. As a result, SME stakeholders can be left with insufficient information to make an informed decision.

Integrated reporting will include key financial information but that information is alongside significant non-financial measures and narrative information. Integrated reporting can help fulfil the communication needs of financial capital and other stakeholders and can optimize reporting.

- (b) (i) Handfood Co should recognise a liability for its obligations as a result of the additional employee benefit net of plan assets. The treatment for these payments is similar to a defined benefit pension scheme, but the difference is that any actuarial gains or losses are recognised immediately and not in other comprehensive income as Handfood Co does at present. Any service costs, net interest and remeasurements should all be recognised in profit or loss. In this case, Handfood Co is going to pay the benefit out of cash and therefore there will be no plan assets. Handfood Co will recognise the net annual change in that liability during the five year period as the service cost. The company will measure the benefit liability at the present value of its obligations at the reporting date. This amount is the estimated amount of benefit that employees have earned in return for their service in the current and prior periods, including benefits that are not yet vested. The benefit is based on future salaries, and therefore the projected unit credit method requires an entity to measure its defined benefit obligations on a basis that reflects estimated future salary increases. The components of the cost of the additional benefit will be recognised in profit or loss which includes the current service cost.

#### **For the year ended 31 December 20X2**

Handfood Co recognises a current service cost expense of \$7,700 in profit or loss as set out below:

	\$'000
Expected final salary \$1.1 million $\times$ (1.03) <sup>4</sup>	<u>1,238</u>
Benefit for the current year (1% $\times$ \$1.238 million)	12.4
Adjusted benefit for the current year (75% $\times$ \$12,400)	<u>9.3</u>
Current service cost (( $\$9,300 \times 0.823$ ) discounted at 5% over 4 years)	<u>7.7</u>

This figure will be unwound each year and the movement recorded as the current service cost (in so far as no other changes to the assumptions are made).

- (ii) An increase in employees' salaries above 3% per annum and a decrease in the probability of employees leaving the company would have the same effect on the additional benefit liability. The changes in the assumptions would both increase the benefit liability (discounted) at 31 December 20X3. This would in turn increase the current service cost for the year in profit or loss as the benefit payable on 1 January



20X7 will have increased as will the number of employees to whom the benefit will be payable.

Interest, which is calculated on the opening balance of the benefit obligation, will not be affected by the changes in assumptions. It will be charged to profit or loss at \$385 ( $\$7,700 \times 5\%$ ). Actuarial gains or losses arise when the assumptions change. In this case because of the changes in assumptions, an actuarial loss will arise because of the increase in benefits payable and the obligation and this will be charged to profit or loss.

## 44 Moorland

**Workbook reference.** Chapter 18: Interpretation of financial statements for different stakeholders.

**Top tips.** Part (a) requires knowledge of the purpose of a management commentary and the requirements of IFRS Practice Statement 1. If you struggled with this, go back and revise the content in Chapter 18.

Part (c) covers alternative performance measures which is a key topic for SBR. You need to consider Moorland's investors in your answer. Wider reading of articles, particularly those on the ACCA website, will be extremely helpful in being able to answer questions such as this. The ESMA (European Securities and Markets Authority) Guidelines on Alternative Performance Measures and IOSCO's (International Organisation of Securities Commissions) Statement on Non-GAAP Financial Measures, both available online, provide another perspective and will be beneficial to read.

**Easy marks.** Some marks are available for the principles of IFRS 8 in part (b).

- (a) The purpose of the management commentary is to provide a context for interpreting a company's **financial position, performance and cash flows**. According to IFRS Practice Statement 1 *Management Commentary*, the principles and objectives of a Management Commentary (MC) are as follows:

- (i) To provide **management's view** of the entity's performance, position and progress
- (ii) To **supplement and complement** information presented in the financial statements

To align with these principles, an MC should include **forward-looking information**, and all information provided should possess the **qualitative characteristics** described in the *Conceptual Framework*.

Practice Statement 1 says that to meet the objective of management commentary, an entity should include information that is essential to an understanding of:

- (i) The **nature of the business**
- (ii) Management's **objectives and its strategies** for meeting those objectives
- (iii) The entity's most significant **resources, risks and relationships**
- (iv) The **results** of operations and **prospects**
- (v) The critical **performance measures and indicators** that management uses to evaluate the entity's performance against stated objectives

The arguments for a mandatory MC are largely to do with content and comparability. It is argued that a mandatory MC will make it easier for companies themselves to judge what is required in such a report and the required standard of reporting, thereby making such reports more **robust, transparent and comparable**. If an MC is not mandatory then there may be **uncertainty** as to content and the possibility of **misinformation**. There is also the risk that, without a mandatory MC, directors may take a **minimalist approach** to disclosure which will make the MC less useful and the information to be disclosed will be in hands of senior executives and directors.



However, the **arguments against** a mandatory MC are that it could **stifle the development of the MC as a tool** for communication and may lead to a **checklist approach** to producing it. It is argued that a mandatory MC is not required as market forces and the needs of investors should lead to companies feeling the pressure to provide a useful and reliable report. The IASB decided to issue a Practice Statement rather than an IFRS and to leave it to regulators to decide who would be required to publish a management commentary. This approach avoids the **adoption hurdle**, ie that the perceived cost of applying IFRSs might increase, which could otherwise dissuade jurisdictions/countries not having adopted IFRSs from requiring its adoption, especially where requirements differ significantly from existing national requirements.

(b) **Operating segment**

IFRS 8 *Operating Segments* describes an operating segment as a component of an entity:

- (1) Which engages in business activities from which it may earn revenues and incur expenses;
- (2) Whose operating results are regularly reviewed by the entity's chief operating decision-maker to make decisions about resources to be allocated to the segment and assess its performance;
- (3) For which discrete financial information is available.

There is a considerable amount of subjectivity in how an entity may apply these criteria to its choice of operating segments. Usually an operating segment would have a segment manager who maintains regular contact with the chief operating decision-maker to discuss operating activities, financial results, forecasts or plans for the segment. Therefore, segment managers could have overall responsibility for a particular product, service line or geographical area and so there could be considerable overlap in how an entity may apply the criteria. In such situations the directors of Moorland should consider the core principles of the standard. Information should be disclosed to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Since Tybull is the only foreign subsidiary, it is likely that separate disclosure is necessary so that users can better assess the performance of Tybull and its significance to the group. The directors should consider whether there are other segments which exhibit similar long-term financial performance and similar economic characteristics to Tybull. In such circumstances it is possible to aggregate the operating segments into a single segment. For example, the segments should have products of a similar nature and similar methods to distribute their products. The segments should also have similar types of customer, production processes and regulatory environment. The directors of Moorland would need to assess whether such aggregation would limit the usefulness of the disclosures for the users of the financial statements. For example, it would no longer be possible to assess the gross margins and return on capital employed for Tybull on an individual basis, without referring to its individual financial statements.

Operating segments can be reclassified where an entity changes its internal organisational structure. As Tybull has not changed its organisational structure, it is unlikely that it would be able to argue for a reclassification of its operating segments. Should the directors of Moorland decide to reclassify the operating segments and combine Tybull with other segments, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would need to be applied. A retrospective adjustment would be required to the disclosures and the change would need to be justified. An entity should only change its policy if it enhances the reliability and relevance of the financial statements. This would appear unlikely given the circumstances.

(c) **Underlying earnings per share**

Underlying earnings per share (underling EPS) is an alternative performance measure (APM). APMs should be provided to enhance the understanding of users of the accounts.

However, APMs can be misleading. Unlike earnings per share, which is defined in IAS 33 *Earnings per Share*, there is no official definition of underlying EPS, so management can choose what items to include or exclude in the underlying earnings. Therefore, it is open to



bias in its calculation as management could decide to only adjust for items that improve the measure. Furthermore, different companies may define the measure in different ways, which reduces the comparability between entities.

The CEO's wish to exclude impairment on goodwill from the calculation of earnings on the basis that it is unlikely to reoccur is also misleading to investors. An impairment loss on goodwill could quite feasibly re-occur in the future as it is at least partly dependent on circumstances outside of Moorland's control, such as the state of the economy. Therefore, it could be argued that excluding the impairment loss would make the measure of underlying earnings per share less useful to investors.

The CEO wishes to present underlying EPS 'prominently'. It is not clear what is meant by this comment, however, Moorland should ensure that it complies with the requirements of IAS 33 regarding the calculation and presentation of this alternative EPS. IOSCO's (International Organisation of Securities Commissions) Statement on Non-GAAP Financial Measures recommends that APMs are not presented more prominently than GAAP measures, or in a way that confuses or obscures GAAP measures.

Ultimately underlying earnings per share will only provide useful information to Moorland's investors if it is fairly presented.

Moorland could improve the usefulness of underlying EPS by:

- Including an appropriate description of how the measure is calculated
- Ensuring that the calculation of underlying EPS is consistent year on year and that comparatives are presented
- Explaining the reasons for presenting the measure, why it is useful for investors and for what purpose management may use it
- Presenting a reconciliation to the most directly reconcilable measure in the financial statements, for example EPS calculated in accordance with IAS 33
- Not excluding items from underlying EPS that could legitimately reoccur in the future, such as impairment losses on goodwill

## 45 Amster

**Workbook references.** Financial instruments are covered in Chapter 8. The *Conceptual Framework* is covered in Chapter 1.

**Top tips.** This question might have alarmed you as you might not have seen a capitalisation table before. However, you must be prepared to encounter disclosures such as this, which are a common feature of published financial statements and useful to investors. You should be able to work out that it requires adjusting in the same way as a statement of financial position would be. For (a)(ii), you need to think about the principles around debt and equity classification for financial instruments and try and relate this to the definitions in the *Conceptual Framework*.

### Marking scheme

	Marks
(a) (i) 1 mark per point up to maximum	8
(ii) 1 mark per point up to maximum	6
(b) 1 mark per point up to maximum	9
Professional marks	<u>2</u>
	<u>25</u>

(a) (i) **Importance of information concerning an entity's capital**

Essentially there are two classes of capital reported in financial statements, namely debt and equity. However, debt and equity instruments can have different levels of right, benefit and risks. Hence, the details underlying a company's capital structure are absolutely essential to assessing the prospects for changes in a company's financial flexibility, and ultimately, its value.

For investors who are assessing the risk profile of an entity, the management and level of an entity's capital is an important consideration. Disclosures about capital are normally in addition to disclosures required by regulators as their reasons for disclosure may differ from those of the International Accounting Standards Board (IASB). The details underlying a company's capital structure are essential to the assessment of any potential change in an entity's financial standing.

Investors have specific but different needs for information about capital depending upon their approach to their investment in an entity. If their approach is income based, then shortage of capital may have an impact upon future dividends. If ROCE is used for comparing the performance of entities, then investors need to know the nature and quantity of the historical capital employed in the business. Some investors will focus on historical invested capital, others on accounting capital and others on market capitalisation.

**Published information**

As an entity's capital does not relate solely to financial instruments, the IASB has included these disclosures in IAS 1 *Presentation of Financial Statements* rather than IFRS 7 *Financial Instruments: Disclosures*. Although IFRS 7 requires some specific disclosures about financial liabilities, it does not have similar requirements for equity instruments.

As a result, IAS 1 requires an entity to disclose information which enables users to evaluate the entity's objectives, policies and processes for managing capital. This objective is obtained by disclosing qualitative and quantitative data. The former should include narrative information such as what the company manages as capital, whether there are any external capital requirements and how those requirements are incorporated into the management of capital. The IASB decided that there should be disclosure of whether the entity has complied with any external capital requirements and, if not, the consequences of non-compliance.

Besides the requirements of IAS 1, IFRS *Practice Statement 1: Management Commentary* suggests that management should include forward-looking information in the commentary when it is aware of trends, uncertainties or other factors which could affect the entity's capital resources. Additionally, some jurisdictions refer to capital disclosures as part of their legal requirements.

In addition to the annual report, an investor may find details of the entity's capital structure where the entity is involved in a transaction, such as a sale of bonds or equities. It can be seen that information regarding an entity's capital structure is spread across several documents including the management commentary, the notes to financial statements, interim financial statements and any document required by securities regulators.

**Integrated reporting**

The capitals identified by the International Integrated Reporting Council (IIRC) are: financial capital, manufactured capital, intellectual capital, human capital, social and relationship capital, and natural capital. Together, they represent stores of value which are the basis of an organisation's value creation. Financial capital is broadly understood as the pool of funds available to an organisation. This includes both debt and equity finance. This description of financial capital focuses on the source of funds, rather than its application which results in the acquisition of manufactured or other forms of capital. Financial capital is a medium of exchange which releases its value through conversion into other forms of capital. It is the pool of funds which is available to the organisation for use in the production of goods or



the provision of services obtained through financing, such as debt, equity or grants, or generated through operations or investments.

- (ii) Whether an instrument is classified as either a financial liability or as equity is important as it has a direct effect on an entity's reported results and financial position. The critical feature of a liability is that, under the terms of the instrument, the issuer is or can be required to deliver either cash or another financial asset to the holder and it cannot avoid this obligation. An instrument is classified as equity when it represents a residual interest in the issuer's assets after deducting all its liabilities. If the financial instrument provides the entity an unconditional discretion, the financial instrument is equity.

IAS 32 *Financial Instruments Presentation* sets out the nature of the classification process but the standard is principle based and sometimes the outcomes are surprising to users. IAS 32 focuses on the contractual obligations of the instrument and considers the substance of the contractual rights and obligations. The variety of instruments issued by entities makes this classification difficult with the application of the principles occasionally resulting in instruments which seem like equity being accounted for as liabilities. Recent developments in the types of financial instruments issued have added more complexity to capital structures with the resultant difficulties in interpretation and understanding.

Equity and liabilities are classified separately in the statement of financial position. The *Conceptual Framework* distinguishes the two elements by the obligation of the entity to deliver cash or other economic resources from items which create no such obligation. The statement of profit or loss and other comprehensive income (OCI) includes income and expenses arising from liabilities which is interest and, if applicable, remeasurement and gain or loss on settlement. The statement does not report as income or expense any changes in the carrying amount of the entity's own equity instruments but does include expenses arising from the consumption of services which fall under IFRS 2 *Share-based Payment*. IFRS 2 requires a valuation of the services consumed in exchange for the financial liabilities or equity instruments.

In the statement of financial position, the carrying amount of many financial liabilities changes either with the passage of time or if the liability is remeasured at fair value. However, the amount reported for classes of equity instruments generally does not change after initial recognition except for non-controlling interest.

Liability classification typically results in any payments on the instrument being treated as interest and charged to earnings. This may in turn affect the entity's ability to pay dividends on its equity shares depending upon local legislation.

Equity classification avoids the negative impact which liability classification has on reported earnings, gearing ratios and debt covenants. It also results in the instrument falling outside the scope of IFRS 9 *Financial Instruments*, thereby avoiding the complicated ongoing measurement requirements of that standard.

- (b) In the case of the first class of preference shares, even though there are negative consequences of not paying dividends on the preferred shares as agreed contractually, the company can avoid the obligation to deliver cash. The preferred shares do have redemption provisions but these are not mandatory and are at the sole discretion of the management committee and therefore the shares should be classified as equity.

In the case of the second class, the contractual term requires no dividend to be paid to ordinary shareholders if a payment is not made on the preferred shares. In this case, as Amster can avoid the obligation to settle the annual dividend, the shares are classified as equity. Thus \$75 million should be transferred from liabilities to equity.

IFRS 2 *Share-based Payment* states that cash settled share-based payment transactions occur where goods or services are paid for at amounts which are based on the price of the company's equity instruments. The expense for cash settled transactions is the cash paid by the company and any amounts accrued should be shown as liabilities and not equity. Therefore, Amster should remove the following amount from equity and show it as a liability.

Expense for year to 30 November 20X7 is:

$$(1,500 - 180 \text{ employees} \times 250 \text{ awards} \times \$35) \times \frac{1}{3} = \$3.85 \text{ million}$$

As a result of the adjustments to the financial statements, Amster's gearing ratio will be lowered significantly as the liabilities will drop from 53.8% of total capitalisation to 33.2% of total capitalisation. However, the ROCE may stay the same even though there is an increase in shareholders equity as total capitalisation has not changed. However, this will depend upon the definition used by the entity for capital employed.

#### Amster Group – capitalisation table

	30 November 20X7	Adjustment	30 November 20X7
	\$m	\$m	\$m
Long-term liabilities	81	3.85	84.85
Pension plan deficit	30		30.00
Cumulative preference shares	<u>75</u>	(75)	<u>–</u>
Liabilities	<u>186</u>		<u>114.85</u>
Non-controlling interest	10		10.00
Shareholders equity	<u>150</u>	(75 – 3.85)	<u>221.15</u>
Group equity	<u>160</u>		<u>231.15</u>
Total capitalisation	<u>346</u>		<u>346.00</u>

## 46 Havanna

**Workbook references.** Revenue recognition is covered in Chapter 3, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* in Chapter 14 and sale and leaseback in Chapter 9.

**Top tips.** Revenue recognition is an area in which preparers of accounts may wish to interpret the standard in such a way as to present the results in a favourable light. In Part (a), you need to explain why the proposed treatment is unacceptable, not just state that it is.

Part (b), which tests IFRS 5, requires clear, logical thinking: there are two potential impairments, the first in calculating the adjusted carrying amount of the disposal group at the time of classification as held for sale, and then again on comparison of this adjusted carrying amount with fair value less costs to sell.

Part (c)(i) requires you to demonstrate wider reading on the impact of IFRS 16. For part (c)(ii), the difficulty with sale and leaseback often lies with identifying whether the transfer of the asset constitutes a sale but here the question actually states that the transaction constitutes a sale so you just need to explain why the directors' understanding is incorrect and advise on the correct accounting treatment in the context of the scenario.

### Marking scheme

	Marks
(a) Revenue recognition – 1 mark per point to a maximum	5
(b) IFRS 5 explanation – 1 mark per point to a maximum	5
(c) (i) Key changes to financial statements from IFRS 16 – 1 mark per point to a maximum	6
(ii) Sale and leaseback – 1 mark per point to a maximum	5
(iii) Effect on interest cover – 1 mark per point to a maximum	2
Professional marks	<u>2</u>
	<u>25</u>



(a) **Contracts with sports organisations**

Havanna has treated the services provided under the contracts as a single performance obligation satisfied at a point in time, when the customer signs the contract.

However, there are **potentially at least three separate performance obligations** in the form of the different services provided by Havanna to the sports organisations. These are access to Havanna's database of members, admission to health clubs and provision of coaching (and other benefits).

Under IFRS 15, Havanna is providing a **series of distinct services** that are **substantially the same** and have the **same pattern of transfer** to the customer.

This is the case because both of the following criteria are met:

- (1) Each distinct service in the series **meets the criteria to be a performance obligation satisfied over time** (ie when the customer simultaneously receives and consumes the benefits provided by the entity). This is the case with all three of the services offered by Havanna to the sports organisations.
- (2) **The same method** would be used to **measure the entity's progress towards complete satisfaction of the performance obligation** to transfer each distinct service in the series to the customer. This is the case for Havanna as the most appropriate measure would be a time-based measure as Havanna has an obligation to provide their services on a continuous basis over the 9 to 18-month contract.

Therefore, Havanna's services qualify as a series of distinct goods and services that are substantially the same which should be grouped together as a **single performance obligation** which is satisfied over time.

For performance obligations satisfied over time, IFRS 15 requires an entity to recognise revenue over time by measuring progress towards complete satisfaction of that performance obligation.

Havanna should recognise revenue on a **straight-line basis over the period of the contract** rather than when the customer signs the contract.

(b) **Sale of division**

The division to be sold meets the criteria in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* to be classified as held for sale and has been classified as a **disposal group** under IFRS 5.

A disposal group that is held for sale should be measured at the **lower of its carrying amount and fair value less costs to sell**. Immediately before classification of a disposal group as held for sale, the entity must recognise impairment in accordance with applicable IFRS. Any impairment loss is generally recognised in profit or loss, but if the asset has been measured at a revalued amount under IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*, the impairment will be treated as a revaluation decrease.

Once the disposal group has been **classified as held for sale**, any further **impairment loss** will be based on the **difference between the adjusted carrying amounts and the fair value less cost to sell**. The impairment loss (if any) will be **recognised in profit or loss**. For assets carried at fair value prior to initial classification, the requirement to deduct costs to sell from fair value will result in an immediate charge to profit or loss.

Havanna has calculated the impairment as \$30 million, being the difference between the carrying amount at initial classification and the value of the assets measured in accordance with IFRS. However, applying the treatment described above:

- |               |   |
|---------------|---|
| <b>Step 1</b> | Calculate carrying amount under applicable IFRS: $\$90\text{m} - \$30\text{m} = \$60\text{m}$   |
| <b>Step 2</b> | Classified as held for sale. Measure at the lower of the adjusted carrying amount under applicable IFRS (\$60m) and fair value less costs to sell of \$38.5 million (\$40m expected sales prices less expected costs of \$1.5m). Therefore, an additional impairment loss of \$21.5 million is required to write down the carrying amount of \$60 million to the fair value less costs to sell of \$38.5 million. |



(c) **Briefing note for directors**

(i) *Key changes investors will see as a result of IFRS 16*

IFRS 16 has brought all lease obligations (with limited exemptions for short-term leases and low value assets) on to the statement of financial position because on lease commencement, a lessee recognises a right-of-use asset and a corresponding lease liability.

Under IAS 17, lessees only recognised an asset and liability in respect of leases that met the definition of a finance lease. Leases that were not classified as finance leases were therefore 'off-balance sheet'. This made investor analysis of financial statements more difficult as investors had to estimate the assets and liabilities resulting from off-balance sheet leases when calculating ratios.

IFRS 16 will reduce complexity in financial statements as it should allow comparisons to be made between those companies who lease assets and those who borrow to buy assets.

The requirement to recognise right-of-use assets and lease liabilities under IFRS 16 will result in more information about leases both on the statement of financial position and in the notes and will provide a more accurate reflection of the impacts of lease arrangements on an entity's financial statements.

The carrying amount of lease assets will typically reduce more quickly than the carrying amount of lease liabilities. This will result in a reduction in reported equity for companies with previous material off-balance sheet leases.

IFRS 16 requires a lessee to disclose lease liabilities separately from other liabilities as a separate line item, or together with other similar liabilities, in a manner which is relevant to understanding the lessee's financial position. A lessee will also split lease liabilities into current and non-current portions, based on the timing of payments.

Investors should bear in mind that some sectors and some companies will be more affected than others. As a result, companies with previous material off-balance sheet leases will report higher assets and financial liabilities.

(ii) *Sale and leaseback*

This is a sale and leaseback transaction which should be accounted for in accordance with IFRS 16 Leases. IFRS 16 requires an **initial assessment** to be made regarding **whether the transfer constitutes a sale**, here we are told the **IFRS 15 criteria have been met**.

Havanna should **derecognise the carrying amount** of the asset (\$4.2m) and **recognise a right-of-use asset** at the proportion of the previous carrying amount that relates to the right-of-use asset retained.

A **gain or loss** should then be recognised in relation to the **rights transferred** to the buyer-lessor. Although there is a gain to be recognised in profit or loss, this will not be the \$0.8 million (being sales price of \$5m – carrying amount of \$4.2m) the CEO has calculated.

Havanna should also recognise a **lease liability** at the present value of the future lease payments of \$3.85 million.

The right-of-use asset at the start of the leaseback should be calculated as:

Carrying amount × present value of future lease payments / Fair value  
= \$4.2m × \$3.85m / \$5m = \$3,234,000.

Havanna should only recognise the amount of gain that relates to the rights transferred. The gain on sale of the building is \$800,000 (\$5,000,000 – \$4,200,000), of which:

$(\$800,000 \times \$3.85m / \$5m) = \$616,000$  relates to the rights retained.

The balance, \$184,000 (\$800,000 – \$616,000), relates to the rights transferred to the buyer and should be recognised as a gain.



At the start of the lease Havanna should account for the transaction as follows:

	Debit \$	Credit \$
Cash	5,000,000	
Right-of-use asset	3,234,000	
Building		4,200,000
Lease liability		3,850,000
Gain on rights transferred		184,000
	<u>8,234,000</u>	<u>8,234,000</u>

The **right-of-use asset** should be **depreciated over ten years** (being the shorter of the lease term and the remaining useful life of the asset). The **gain will be recognised in profit or loss** and the **lease liability** will be **increased** each year by the **interest charge** and **reduced by the lease payments**.

(iii) *Effect on interest cover*

The interest cover ratio in its most simple form is an entity's earnings before interest and tax divided by its interest expense for the period. In stating that the transaction will help to ensure that the interest cover covenant will be met, the CEO has failed to take into account the additional finance cost that will arise as a result of the lease liability.

Furthermore, earnings will be increased by the gain on the rights transferred of \$0.184 million, but this is far less than the \$0.8 million gain expected by the CEO. More information would be required as to the interest payable on the lease in order to quantify whether the interest cover will indeed improve as a result of the sale and leaseback.

## 47 Operating segments

**Workbook references.** The topics in this question are covered in Chapter 18.

**Top tips:** Parts (a) and (b) require you to apply the criteria in IFRS 8 to two different companies. In (a) you need to consider the allocation of common costs to operating segments and explain how those costs differ to amounts in the financial statements because IFRS 8 is based on internally reported information. In (b) you need to determine whether the company was correct in aggregating two reportable segments (there is plenty of information in the scenario to suggest otherwise) and consider how investors use segmental information in their appraisal of companies. Part (c) considers the disclosure of social and environmental information in financial statements.

**Easy marks.** There are some easy marks for definitions in Part (b).

### Marking scheme

	Marks
(a) Accell – allocation of common costs – discussion 1 mark per point to a maximum of 7 marks. Points may include:	
Impact on profit/net assets of allocation	1
IFRS 8 guidance on allocation	1
Suggested basis for allocation for each cost in scenario	3
Differing amounts in segment report to financial statements	<u>2</u>
	7

			Marks
(b)	(i)	Velocity – application of IFRS 8:	
		Criteria for aggregation	1
		Customer base/risk	2
		Conclusion	<u>1</u>
			4
	(ii)	Velocity – discussion of investor appraisal and segments:	
		Used to determine cash flows	1
		Aggregation less useful	1
		Conclusion	1
		Ethics	<u>1</u>
			4
(c)		1 mark per relevant well-explained point	8
		Professional marks	<u>2</u>
			<u>25</u>

(a) **Accell – allocation of common costs under IFRS 8**

If operating segment disclosure is to fulfil a useful function, costs need to be appropriately assigned to segments. Centrally incurred expenses and central assets can be significant, and the basis chosen by an entity to allocate such costs **can therefore have a significant impact** on the financial statements. In the case of Accell, head office management expenses, pension expenses, the cost of managing properties and interest and related interest-bearing assets could be material amounts, whose misallocation could mislead users.

IFRS 8 **does not prescribe a basis** on which to allocate common costs, but it does require that that basis should be **reasonable**. For example, it would not be reasonable to allocate the head office management expenses to the most profitable business segment to disguise a potential loss elsewhere. Nor would it be reasonable to allocate the pension expense to a segment with no pensionable employees.

A reasonable basis on which to allocate common costs for Accell might be as follows:

- (i) **Head office management costs.** These could be allocated on the basis of revenue or net assets. Any allocation might be criticised as arbitrary – it is not necessarily the case that a segment with a higher revenue requires more administration from head office – but this is a fairer basis than most.
- (ii) **Pension expense.** A reasonable allocation might be on the basis of the number of employees or salary expense of each segment.
- (iii) **Costs of managing properties.** These could be allocated on the basis of the value of the properties used by each business segment, or the type and age of the properties (older properties requiring more attention than newer ones).
- (iv) **Interest and interest-bearing assets.** These need not be allocated to the same segment – the interest receivable could be allocated to the profit or loss of one segment and the related interest-bearing asset to the assets and liabilities of another. IFRS 8 calls this asymmetrical allocation.

The **amounts reported under IFRS 8 may differ from those reported in the financial statements** because IFRS 8 requires the information to be presented on the same basis as it is reported internally, even if the accounting policies are not the same as those of the consolidated financial statements. For example, segment information may be reported on a cash basis rather than an accruals basis or different accounting policies may be adopted in the segment report when allocating centrally incurred costs if necessary for a better understanding of the reported segment information.

IFRS 8 requires **reconciliations** between the segments' reported amounts and those in the consolidated financial statements. Entities must disclose the nature of such differences, and of the basis of accounting for transactions between reportable segments.



(b) (i) **Velocity – operating segments**

IFRS 8 *Operating Segments* requires operating segments to be reported separately if they exceed at least one of certain quantitative thresholds. An entity can choose to aggregate two or more operating segments into a single operating segment **before** applying the quantitative thresholds if those operating segments have **similar economic characteristics**, and the segments are similar in **all** of the following aggregation criteria:

- (i) The nature of the products and services
- (ii) The nature of the production process
- (iii) The type or class of customer for their products or services
- (iv) The methods used to distribute their products or provide their services
- (v) If applicable, the nature of the regulatory environment.

Operating segments can also be aggregated if, after applying the quantitative thresholds, no operating segments are found to be reportable, in order to produce a reportable segment. This can only be done if the operating segments have **similar economic characteristics**, and the segments are similar in a **majority** of the above aggregation criteria.

Management have a choice as to whether to aggregate operating segments that meet the aggregation criteria. But in making that choice, management must consider the core principle of IFRS 8 which is to provide useful information to users in evaluating the business.

Velocity has aggregated segments 1 and 2, but this aggregation may not be permissible under IFRS 8. While the products and services are similar, the **customers for those products and services are different**. Therefore, the third aggregation criteria has not been met.

In the local market, the decision to award the contract is in the hands of the local authority, which also sets prices and pays for the services. The **company is not exposed to passenger revenue risk**, since a contract is awarded by competitive tender.

By contrast, in the inter-city train market, the **customer ultimately determines whether a train route is economically viable** by choosing whether or not to buy tickets. Velocity sets the ticket prices, but will be influenced by customer behaviour or feedback. The **company is exposed to passenger revenue risk**, as it sets prices which customers may or may not choose to pay.

It is possible that the fifth criteria, regulatory environment, is not met, since the local authority is imposing a different set of rules to that which applies in the inter-city market.

In conclusion, the two segments have different economic characteristics and so **should be reported as separate segments** rather than aggregated.

(ii) **Relevance to investor analysis**

Contrary to the managing director's views, IFRS 8 provides information that makes the financial statements more useful to investors. The objective of financial statements is to provide financial information to primary users (not just investors) which enables them to make decisions about providing resources to the entity.

In making those decisions, investors and creditors consider the returns they are likely to make on their investment. This requires assessment of the amount, timing and uncertainty of the future cash flows of Velocity as well as of management's stewardship of Velocity's resources. How management derives profit is therefore relevant information to an investor.

Inappropriately aggregating segments reduces the usefulness of segment disclosures to investors. IFRS 8 requires information to be disclosed that is not readily available elsewhere in the financial statements, therefore it provides additional information which aids an investor's understanding of how the business operates and is managed.

In Velocity's case, if the segments are aggregated, then the increased profits in segment 2 will hide the decreased profits in segment 1. However, the fact profits have sharply declined in segment 1 would be of interest to investors as it may suggest that future cash flows from this segment are at risk.

The fact that the director was pleased at the aggregation of the segments raises concern that perhaps Velocity is trying to conceal facts from investors. The reasons for this should be investigated further to determine if there is any unethical practice taking place.

(c) **Social and environmental information**

There are a number of factors which encourage companies to disclose social and environmental information in their financial statements. **Public interest** in corporate social responsibility has increased in recent years and in an age where society is increasingly aware of the impact of both individual and business decisions on the climate, environment and sustainability, it remains a key area of focus for reporting accountants.

Although financial statements are intended for present and potential investors, lenders and other creditors, there is recognition that companies have a responsibility to **a number of different stakeholders**. These include **customers, employees and the general public**, all of whom are **potentially interested** in the way in which a company's operations affect the natural environment and the wider community. These stakeholders can have a **considerable effect on a company's performance**. As a result, most companies now take positive steps to build a **reputation for social and environmental responsibility**. Therefore, the disclosure of environmental and social information is essential.

It is also generally accepted that **corporate social responsibility is actually an important part of an entity's overall performance**. Responsible practice in areas such as reduction of damage to the environment and fair recruitment practices **increase shareholder value**. Companies that act responsibly and make social and environmental disclosures are **perceived as better investments** than those that do not.

Another factor is **commitments by governments** to achieve, for example, climate change targets or to meet Sustainable Development Goals by 2030 and the pressure placed on companies to make a positive contribution towards achieving such targets. Although there are **no IFRS Standards** that specifically require environmental and social reporting, it may be required by **company legislation** and **stock exchange requirements**. There are now a number of **awards for environmental and social reports** and high-quality disclosure in financial statements. These provide further encouragement to disclose information.

At present companies are normally able to disclose **as much or as little information as they wish in whatever manner that they wish**. This causes a number of **problems**. Companies tend to disclose information **selectively** and it is difficult for users of the financial statements to **compare the performance of different companies**. However, there are **good arguments** for continuing to allow companies a certain amount of freedom to determine the information that they disclose. If detailed rules are imposed, **companies are likely to adopt a 'checklist' approach** and will **present information in a very general and standardised way**, so that it is of very little use to stakeholders.