

48 Cloud

Workbook references. Integrated Reporting and other aspects of performance reporting are covered in Chapter 18 of the Workbook. The *Conceptual Framework* is covered in Chapter 1. Hedge accounting is covered in Chapter 8 and transfers from the revaluation surplus are covered in Chapter 4.

Top tips. Part (a) of the question covered two topics: the issue of recognition of income and expenses in profit or loss vs other comprehensive income, reclassification between the two, and integrated reporting. Because the question is fairly open-ended, our answer is longer than would be needed in an exam where only some of the points would need to be made in order to get the marks.

Part (b) required the application of Part (a) in terms of determining which elements of a profit or loss should be reported in OCI and which elements in profit or loss.

Easy marks. Describing the principles and key components of the <IR> Framework is straightforward textbook knowledge. Other than the hedge accounting, Part (b) on the measurement of assets should be relatively easy.

Marking scheme

| | | Marks |
|-----|--------------------------------------|-----------|
| (a) | (i) 1 mark per point up to maximum | 6 |
| | (ii) 1 mark per point up to maximum | 5 |
| | (iii) 1 mark per point up to maximum | 8 |
| (b) | 1 mark per point up to maximum | <u>6</u> |
| | | <u>25</u> |

(a) (i) Current presentation requirements

IAS 1 requires the presentation of either one combined statement of profit or loss and other comprehensive income (SPLOCI) or two separate statements, the statement of profit or loss (SPL) and the statement of comprehensive income.

Separate disclosure is required of those items of other comprehensive income (OCI) which would be reclassified to profit or loss and those items of OCI which would never be reclassified to profit or loss, along with the related tax effects of each category.

Conceptual basis

The conceptual basis for what should be classified as OCI is not clear. This has led to an **inconsistent use of OCI in IFRS**.

Opinions vary but there is a feeling that **OCI has become a home for anything controversial** because of a lack of clear definition of what should be included in the statement.

Many users are thought to ignore OCI, as the changes reported are not caused by the operating flows used for predictive purposes. It is also difficult for users to understand the concept of OCI as opposed to profit or loss which, although subject to accounting standards, is an easier notion to grasp.

The definitions of profit and loss and OCI in IAS 1 are not particularly helpful in understanding the conceptual basis:

- Profit or loss is the total of all items of income and expenses except those items of income or expense which are recognised in OCI
- OCI comprises items of income and expense that are not recognised in profit or loss as required or permitted by other IFRSs

The IASB has been asked to define what financial performance is, clarify the meaning and importance of OCI and how the distinction between profit or loss and OCI should be made in practice. Many stakeholders were hoping that the *Conceptual Framework* as revised in 2018 would answer these questions, but the matter has not been adequately addressed.

The revised *Conceptual Framework* identifies the SPL as the **primary source** of information about an entity's performance and states that in principle, therefore, all income and expenses are included in it.

However, it goes on to say that in developing IFRSs the IASB may include income or expenses **arising from a change in the current value of an asset or liability as OCI** when they determine it provides more relevant information or a more faithful representation.

So although there is more guidance on what constitutes OCI, the conceptual basis for it is still not clear.

(ii) **Reclassification adjustments**

Reclassification adjustments are **amounts reclassified to profit or loss in the current period which were recognised in OCI in the current or previous periods**.

Items which may be reclassified include foreign currency gains on the disposal of a foreign operation and realised gains or losses on cash flow hedges.

Items which may not be reclassified are changes in a revaluation surplus under IAS 16 *Property, Plant and Equipment*, and actuarial gains and losses on a defined benefit plan under IAS 19 *Employee Benefits*.

However, the notion of reclassification and when or which OCI items should be reclassified is not clear. The revised *Conceptual Framework* (2018) states that in principle, OCI is recycled to profit or loss in a future period when doing so results in the provision of more relevant information or a more faithful representation. While providing more guidance than the previous *Conceptual Framework*, the conceptual basis for when OCI should be reclassified is not clear.

Arguments for and against reclassification

It is argued that reclassification protects the integrity of profit or loss and **provides users with relevant information about a transaction which occurred in the period**. Additionally, it can **improve comparability** where IFRSs permits similar items to be recognised in either profit or loss or OCI.

Those against reclassification argue that the **recycled amounts add to the complexity of financial reporting**, may lead to earnings management and the reclassification adjustments may not meet the definitions of income or expense in the period as the change in the asset or liability may have occurred in a previous period.

(iii) **Integrated Reporting**

The <IR> Framework establishes **principles** and **concepts** which govern the overall content of an integrated report. This enables each company to set out its own integrated report rather than adopting a checklist approach.

The integrated report aims to provide an insight into the company's resources and relationships (known as **capitals**) and how the company interacts with the external environment and the capitals to create value. These capitals can be financial, manufactured, intellectual, human, social and relationship, and natural capital but companies need not adopt these classifications.

Integrated reporting is built around the following key components:

- (1) Organisational overview and the external environment under which it operates
- (2) Governance structure and how this supports its ability to create value
- (3) Business model
- (4) Risks and opportunities and how they are dealing with them and how they affect the company's ability to create value
- (5) Strategy and resource allocation
- (6) Performance and achievement of strategic objectives for the period and outcomes
- (7) Outlook and challenges facing the company and their implications
- (8) The basis of presentation needs to be determined including what matters are to be included in the integrated report and how the elements are quantified or evaluated

An integrated report should provide insight into the **nature and quality of the organisation's relationships** with its **key stakeholders**, including how and to what extent the organisation understands, takes into account and responds to their **needs and interests**. The report should be consistent over time to enable comparison with other entities.

'Value' depends upon the individual company's own perspective. It can be shown through movement of capital and can be defined as **value created for the company or for others**. An integrated report should not attempt to quantify value, as assessments of value are left to those using the report.

An integrated report does not contain a statement from those 'charged with governance' acknowledging their responsibility for the integrated report. This may undermine the reliability and credibility of the integrated report.

There has been discussion about whether the <IR> Framework constitutes suitable criteria for report preparation and for assurance. There is a degree of uncertainty as to measurement standards to be used for the information reported and how a preparer can ascertain the completeness of the report. The IIRC has stated that the prescription of specific measurement methods is beyond the scope of a principles-based framework.

The <IR> Framework contains information on the principles-based approach and indicates that there is a need to include quantitative indicators whenever practicable and possible. Additionally, consistency of measurement methods across different reports is of paramount importance. There is outline guidance on the selection of suitable quantitative indicators.

There are additional concerns over the ability to assess future disclosures, and there may be a need for confidence intervals to be disclosed. The preparation of an integrated report requires judgement but there is a requirement for the report to describe its basis of preparation and presentation, including the significant frameworks and methods used to quantify or evaluate material matters. Also included is the disclosure of a summary of how the company determined the materiality limits and a description of the reporting boundaries.

A company should consider how to describe the disclosures without causing a significant loss of competitive advantage. The entity will consider what advantage a competitor could actually gain from information in the integrated report, and will balance this against the need for disclosure.

- (b) At 30 April 20X5, Cloud should write down the steel, in accordance with IAS 2 *Inventories*, to its net realisable value of \$6 million, therefore reducing profit by \$2 million. Cloud should reclassify an equivalent amount of \$2 million from equity to profit or loss. Thus there is no net impact on profit or loss from the write down of inventory. The gain remaining in equity of \$1 million will affect profit or loss when the steel is sold. Therefore, on 3 June 20X5, the gain on the sale of \$0.2 million will be recognised in profit or loss, and the remaining gain of \$1 million will be transferred to profit or loss from equity.

As regards the property, plant and equipment, at 30 April 20X4, there is a revaluation surplus of \$4 million being the difference between the carrying amount of \$8 million (\$10 million – \$2 million) and the revalued amount of \$12 million. This revaluation surplus is recognised in other comprehensive income.

At 30 April 20X5 the asset's value has fallen to \$4 million and the carrying amount of the asset is \$9 million (\$12 million – \$3 million). The entity will have transferred \$1 million from revaluation surplus to retained earnings, being the difference between historical cost depreciation of \$2 million and depreciation on the revalued amount of \$3 million. The revaluation loss of \$5 million will be charged first against the revaluation surplus remaining in equity of (\$4 million – \$1 million), ie \$3 million and the balance of \$2 million will be charged against profit or loss.

IAS 1 requires an entity to present a separate statement of changes in equity showing amongst other items, total comprehensive income for the period, reconciliations between the carrying amounts at the beginning and the end of the period for each component of equity, and an analysis of other comprehensive income.

49 Leria Co

Workbook references. Non-current assets held for sale are covered in Chapter 14. Sale and leaseback is covered in Chapter 9. Intangible assets are covered in Chapter 4.

Top tips. This question was set in the context of a football club, however industry-specific knowledge was not required. Part (a) contained three separate sub-requirements, all related to the treatment of the football stadium. Part (a)(i) required careful application to the scenario of the requirements of IFRS 5 for assets held for sale relating to the date of the sale agreement. In part (a)(ii), you were told in the scenario that the company's accounting treatment for the crowd barriers was incorrect, so that gave you a starting point for the discussion. Part (a)(iii) covered the sale and leaseback. This is where you should have spent most of your time in part (a) as there was lots to discuss. Part (b)(i) was tricky if you were not aware of the rebuttable presumption in IAS 38 that that basing amortisation on revenue, for which the intangible is used, is inappropriate, unless both use and revenue are highly correlated. However, if you were not aware of this, you could have described the principles underlying amortisation and developed your answer from there. Part b(ii) required a discussion of the accounting treatment of the players' contract costs, including contingent performance conditions, the possible need for impairment and whether a player can be considered a single cash generating unit (CGU).

Marking scheme

| | | Marks |
|-----|--|-----------|
| (a) | Discussion and application of the following to the scenario: | |
| | (i) Held for sale guidance under IFRS 5 | 3 |
| | (ii) Accounting treatment barrier improvements | 3 |
| | (iii) Sale and leaseback principles | 4 |
| | Accounting treatment sale and leaseback | <u>3</u> |
| | | 13 |
| (b) | Discussion and application of the following to the scenario: | |
| | Potential amortisation of the intangible asset | 5 |
| | Performance conditions and contract costs | 5 |
| | Value-in-use of an individual player/CGU | <u>2</u> |
| | | <u>12</u> |
| | | <u>25</u> |

- (a) (i) IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* addresses the accounting for assets which are classified as held for sale. IFRS 5 requires a non-current asset to be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through its continuing use. It must be available for immediate sale in its present condition, and its sale must be highly probable within 12 months of classification as held for sale. The standard only foresees an exemption to this rule if the sale is delayed by events or circumstances which are beyond the entity's control, which is unlikely to be the case in this instance. Leria Co has entered into a firm sales commitment but the sale will occur after the 12-month threshold. Therefore, the stadium cannot be classified as held for sale. Additionally, a sale and leaseback transaction is outside the scope of IFRS 5 and is covered by IFRS 16 *Leases*.
- (ii) The \$2 million to be spent on crowd barrier improvements to the stadium should not be treated as an impairment of the asset's carrying amount at 31 October 20X5. There is no present obligation (legal or constructive) as a result of a past event and there is no probable payment. Leria Co may decide not to carry out the improvements, especially as the stadium is going to be sold and then subsequently leased back. Therefore the \$2 million should be added back to the carrying amount of the stadium and a corresponding credit made to profit or loss.
- (iii) A sale and leaseback transaction occurs where an entity transfers an asset to another entity and leases that asset back from the buyer/lessor. The first required criteria of IFRS standards is to determine whether a sale has occurred. Under IFRS 16, an entity must apply the IFRS 15 *Revenue from Contracts with Customers* requirements to determine when a performance obligation is satisfied. If it is concluded that the transfer of an asset is not a sale, then the seller/lessee will continue to recognise the transferred asset. In this event, a financial liability and financial asset will be recognised under IFRS 9 *Financial Instruments*. In this case, it seems that a sale will occur on 30 November 20X6 because of the binding sale commitment. If the fair value of the sale consideration equals the asset's fair value, and the lease payments are at market rates, there is no need to adjust the sales proceeds under IFRS 16.

Leria Co should follow IFRS 15 to account for the sale and then apply IFRS 16 to account for the lease. Thus, Leria Co should account for the sale and leaseback as follows:

- Derecognise the underlying asset.
- Recognise the sale at fair value.
- Recognise only the gain/loss which relates to the rights transferred to buyer/lessor.
- Recognise a right-of-use asset as a proportion of the previous carrying amount of the underlying asset.
- Recognise a lease liability.

Leria Co should account for the sale and leaseback at 30 November 20X6 as follows:

| | |
|--|------------------------|
| Carrying amount of stadium is \$(18 + 2) million = | \$20 million |
| Less Depreciation for year to 31 October 20X6 \$(20 × .05) million | (\$1 million) |
| Depreciation for November 20X6 \$(20 – 1) × .05/12) million | (\$0.08 million) |
| | <u>\$18.92 million</u> |

Present value of lease/fair value of asset = \$26m/\$30 × 100% = 86.67%

The right-of-use asset recorded will be 86.67% × \$18.92 = \$16.4 million.

Tutorial note:

The following will be the entries in the financial records:

| | Dr (\$m) | Cr (\$m) |
|----------------------------|-------------|-------------|
| Cash | 30 | |
| ROU asset | 16.4 | |
| Stadium | | 18.92 |
| Lease liability | | 26 |
| Gain on disposal (balance) | | 1.48 |
| | <u>46.4</u> | <u>46.4</u> |

The gain on disposal is limited to the gain on the portion of the asset sold recognising that Leria has retained an interest in the asset. It will be reported in the statement of profit or loss.

- (b) (i) Leria Co's accounting policy to base the amortisation of the intangible asset for content rights on revenue stemming from the rights seems reasonable and systematic. However, IAS 38 *Intangible Assets* sets out a rebuttable presumption that amortisation based on revenue generated by an activity which includes the use of an intangible asset is not appropriate. This presumption can be overcome when it can be demonstrated that revenue and the consumption of the economic benefits of the intangible asset are highly correlated. The intellectual property embodied in the television programmes will generate cash flows through the television channel subscriptions and the estimated revenues for a television programme determine the amount to be spent on producing the television programme. Therefore, revenue reflects a proxy for the pattern of consumption of the benefits received. Revenue and consumption of the economic benefits of the intangible asset seem highly correlated and therefore a revenue-based amortisation method seems appropriate.

The industry practice method is also acceptable and conceptually sound as it is based on an analysis of the remaining useful life of the programme and the recoverable amount. Such an approach does not contradict IAS 38's prohibition on revenue-based amortisation because it is not based on direct matching of revenue and amortisation. The useful life of an asset is required to be reassessed in accordance with IFRS Standards at least at each financial year end. Where this results in a change in estimate, this will be accounted for prospectively from the date of reassessment.

IAS 38 also states that if a pattern of amortisation cannot be measured reliably, the straight-line method must be used.

- (ii) When a player's contract is signed, management should make an assessment of the likely outcome of performance conditions. Contingent consideration will be recognised in the players' initial registration costs if management believes the performance conditions will be met in line with the contractual terms. Periodic reassessments of the contingent consideration should be made. Any contingent amounts which the directors of Leria Co believe will be payable should be included in the players' contract costs from the date management believes that the performance conditions will be met. Any additional amounts of contingent consideration not included in the costs of players' registrations will be disclosed separately as a commitment. Amortisation of the costs of the contract will be based upon the length of the player's contract.

The costs associated with the renegotiation of a playing contract should be added to the residual balance of the players' contract costs at the date of signing the contract extension. The revised carrying amount should be amortised over the remaining renegotiated contract length. Where a player sustains a career threatening injury and is removed from the playing team, the carrying amount of the individual would be assessed against the best estimate of the individual's fair

value less any costs to sell and an impairment charge made in operating expenses reflecting any loss arising.

It is unlikely that any individual player can be a separate single cash generating unit (CGU) as this is likely to be the playing squad. Also, it is difficult to determine the value-in-use of an individual player in isolation as players cannot generate cash flows on their own unless via a sale.

50 Corbel Co

Marking scheme

| | | Marks |
|-----|---|-----------|
| (a) | Listing of major challenges 1 mark per point up to maximum | 5 |
| (b) | Discussion and application of the following to the scenario: | |
| | (i) Treatment of brand on acquisition | 2 |
| | Allocation of brand to CGU | <u>2</u> |
| | | 4 |
| | (ii) Intangible assets with indefinite life principles (IAS 38) | 2 |
| | Application to scenario | <u>4</u> |
| | | 6 |
| | (iii) NCA held for sale-principles | 3 |
| | Application to scenario | <u>3</u> |
| | | 6 |
| | (iv) Impairment principles | 2 |
| | Impairment of primary store | <u>2</u> |
| | | <u>4</u> |
| | | <u>25</u> |

- (a) There are many challenges in recognising and measuring intangible assets such as brands in the statement of financial position.

Many intangible assets are not frequently traded on a stand-alone basis and therefore very often there is no active market for them which makes arriving at a valuation more difficult. Additionally, many intangible assets are unique and therefore it is not easy to identify and assess their value. Valuation methods are often complex and subjective and the measurement is more subjective when the intangible assets are not based on legally enforceable rights. In some cases, the acquirer does not intend to use the intangible assets (for example, Corbel has acquired the brands for defensive reasons) and this raises issues with regards to arriving at a value. Finally, determining the useful life of intangible assets can be subjective.

Generally, the reason for the omission from the financial statements of intangible assets has been due to a perceived lack of a link between their costs and estimating future revenue. In addition, the difficulties in ascertaining cost or valuation figures for intangibles and a focus on reliability over relevance when disclosing asset information have meant that internally generated intangibles have not usually been recognised. However, the importance of intangibles is reflected in the increasing proportion of a company's market value being attributable to the existence of intangibles.

Intangible assets are not physical assets that can be easily recognised. In some cases, perceptions may clash and what may seem like an intangible asset to one party may appear not so to another.

- (b) (i) The Jengi brand will generate future economic benefits by increasing sales volumes and by the potential of premium prices. Control over these potential future benefits is achieved by the registration of the brand. The registration also satisfies the requirement to identify the intangible asset separately from goodwill and estimate its fair value.

IAS 36 *Impairment of Assets* defines a cash generating unit (CGU) as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or other groups of assets. However, brands are typically not a separate CGU under IFRS. The brand would be tested for impairment together with the associated manufacturing facilities. The brand would be separately identified and valued, and should be allocated to each of Corbel Co's cash generating units that are expected to benefit from the synergies of the combination. IAS 36 recognises that sometimes there is no basis for allocating the brand to an individual CGU that is not arbitrary, so it permits it to be allocated to a group of CGUs. However, each CGU must represent the lowest level within the entity that is monitored for internal management purposes and not be larger than an operating segment.

- (ii) Intangible assets have an indefinite useful life when there is no foreseeable limit to the period over which, based on an analysis of all relevant factors, the asset is expected to generate net cash inflows for the entity (IAS 38 *Intangible Assets*). An intangible asset with an indefinite useful life should not be amortised. IAS 36 *Impairment of Assets*, requires an entity to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount:

- (a) annually, and
- (b) whenever there is an indication that the intangible asset may be impaired.

The useful life of an intangible asset that is not being amortised should be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate in accordance with IAS 8 *Account Policies, Changes in Estimates and Errors*.

Corbel Co should consider various factors to determine whether the brand names can be considered to have a useful life. These will include the extent to which Corbel Co is prepared to support the brand and the extent to which the brand has long-term potential and has had proven success. Perfume is often subject to market and fashion trends and therefore, an assessment of how resistant the brands are to change should be made. Also Corbel Co has purchased the brands as a defensive measure to prevent rival companies acquiring them. Therefore, there may be a doubt as to the support that Corbel Co may be prepared to give to the brands.

The Locust perfume has been sold successfully in the market for many years and could be deemed to have an indefinite life. The Clara perfume is linked to the popularity of the actor and therefore, it is difficult to assess whether the brand has an indefinite life as it is likely to be dependent upon the longevity of the popularity of the actor. In the case of the Clara perfume, it is difficult to state that the brand will have an indefinite life. Thus, Clara is likely to have a finite life.

- (iii) IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* states that immediately before classifying a disposal group as held for sale, the carrying amounts of the assets and liabilities within the group are measured in accordance with the applicable IFRS standards. After classification as held for sale, disposal groups are measured at the lower of carrying amount and fair value less costs to sell. Impairment must be considered both at the time of classification as held for sale

and subsequently after classification. The six stores should be accounted for as a discontinued operation as they represent a component of Corbel Co and are a separate geographical area of operations. The approval and announcement of a plan to close the six Italian stores is an indication that the assets attributable to the discontinuing operation may be impaired. In addition, the six stores would be classified as a 'disposal group' which is a group of assets that, an entity intends to dispose of in a single transaction. The measurement basis required for non-current assets classified as held for sale is applied to the group as a whole, and any resulting impairment loss reduces the carrying amount of the non-current assets in the disposal group in the order of allocation required by IAS 36. Additionally, there may be a need to provide for the additional costs of closure such as redundancy costs, under IAS 37 *Provisions, Contingent liabilities and Contingent Assets*.

At the end of each reporting period, an entity is required to assess whether there is any indication that an asset may be impaired, ie its carrying amount may be higher than its recoverable amount. IAS 36 has a list of external and internal indicators of impairment. If there is an indication that an asset may be impaired, then the asset's recoverable amount must be calculated. Whenever there is an indication of impairment, the entity estimates the recoverable amount of the asset and records an impairment if the recoverable amount is lower than the carrying amount.

Although there has been a local newspaper article that Corbel Co is to shut 30 stores with a loss of 500 jobs across the world over the next five years, there has been no formal announcement by Corbel Co and therefore, until there has been formal plans drawn up to close the additional stores there should be no provisions made for the stores potential closure and loss of jobs. It is feasible that the closure of the additional 24 stores will not take place, and there is no constructive obligation unless there is at least a detailed formal plan. The directors have denied the fact that the additional stores will be closed.

- (iv) As stated in (a)(ii), an entity needs to assess at the end of each reporting period whether there is any indication that an asset may be impaired. An indication of impairment is whether the performance of the asset is worse than expected. As the primary store is performing in line with expectations, it would appear that at present, there is no indication of impairment and therefore no impairment test is required. Additionally, if Corbel Co feels that the primary store benefits all the other stores from a brand perspective, it may be appropriate to treat the store as a corporate asset and allocate its cost to the other stores for impairment testing. The amount of internet sales included in any impairment assessment of the primary store will depend on the quantity of sales that are sourced directly from it. Where Internet sales are sourced from a central warehouse or another store, the cash inflows should be excluded from the primary store's impairment assessment and included in the appropriate CGU.

51 Fill

Marking scheme

| | | Marks |
|-----|---|----------|
| (a) | A discussion of potential measurement basis, NRV and relevant Standards | 3 |
| | Application of IAS 2 to the scenario | <u>4</u> |
| | | 7 |
| (b) | A discussion of IAS 16 and application to the scenario | 4 |
| | A discussion of IAS 36 and application to the scenario | <u>4</u> |
| | | 8 |

| | | Marks |
|-----|---|-----------|
| (c) | A discussion of control in the <i>Conceptual Framework</i> and other relevant Standards | 4 |
| | A discussion of a business combination per IFRS 3 | 2 |
| | Application of the above discussions to the scenario | 4 |
| | | <u>10</u> |
| | | <u>25</u> |

- (a) Inventories should be valued at the lower of cost and net realisable value. The *Conceptual Framework* acknowledges a variety of measurement bases including historical cost, current cost, value-in-use and fair value. Historical cost is consistent with the cost valuation in IAS 2 *Inventories*, however value in use and fair value are not:

- Value-in-use requires the use of the present value of future cash flows.
- Fair value is a market-based measurement, not an entity-specific measurement. When determining fair value, the assumptions used are those that market participants would use when pricing the asset, this would not take into consideration entity-specific factors like the cost needed to complete an asset and sell it.

The *Conceptual Framework* is not a Standard and does not override the requirements of a Standard, therefore in order to determine NRV, the directors would need to refer to IAS 2.

IAS 2 defines NRV as the estimated selling price in the ordinary course of business less the costs of completion and costs of sale.

NRV is an entity-specific measure which should be determined on the basis of conditions which existed at the date of the statement of financial position.

To estimate NRV, Fill should take into consideration future price movements if they provide information about the conditions at the reporting date. However, normally these movements would reflect changes in the market conditions after that date and therefore would not affect the calculation of NRV.

The NRV will be based upon the most reliable estimate of the amounts which will be realised for the coal.

Fill should calculate the NRV of the low carbon coal using the forecast market price based upon when the inventory is expected to be processed and realised. The forecast market price should be adjusted for the time value of money (where this is material) and for processing and selling costs to give a reasonable estimate of NRV.

Future changes in the forecast market price or the processing and sale of the low carbon coal may result in adjustments to the NRV. As these adjustments are changes in estimates, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* will apply with the result that such gains and losses will be recognised in the statement of profit or loss in the period in which they arise.

Tutorial note.

The year-end spot price will provide good evidence of the realisable value of the inventories at the year end. The forward contract price may be appropriate if the company has an executory contract to sell coal at a future date. However, if the company does not have an executory contract, but instead a financial instrument under IFRS 9 *Financial Instruments* or an onerous contract recognised as a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the forward contract price is unlikely to be used to calculate NRV.

- (b) IAS 16 *Property, Plant and Equipment* (PPE) requires an entity to recognise in the carrying amount of PPE the cost of replacing part of such an item. When each major inspection is performed, its cost is recognised in the carrying amount of the item of PPE as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of a previous inspection is derecognised. The costs of performing a major reconditioning are capitalised if it gives access to future economic benefits. Such costs will include the labour and materials costs (\$3 million) of performing the reconditioning. However, costs which do not relate to the replacement of components or the installation of new assets, such as routine maintenance costs, should be expensed as incurred.

It is not acceptable to accrue the costs of reconditioning equipment as there is no legal or apparent constructive obligation to undertake the reconditioning. As set out above, the cost of the reconditioning should be identified as a separate component of the mine asset at initial recognition and depreciated over a period of two years. This will result in the same amount of expense being recognised as the proposal to create a provision.

IAS 36 *Impairment of Assets* says that at the end of each reporting period, an entity is required to assess whether there is any indication that an asset may be impaired. IAS 36 has a list of external and internal indicators of impairment. If there is an indication that an asset may be impaired, then the asset's recoverable amount must be calculated.

Past and future reductions in selling prices may indicate that the future economic benefits which relate to the asset have been reduced. Mining assets should be tested for impairment whenever indicators of impairment exist. Impairments are recognised if a mine's carrying amount exceeds its recoverable amount. However, the nature of mining assets is that they often have a long useful life. Commodity prices can be volatile but downward price movements are more significant if they are likely to persist for longer periods. In this case, there is evidence of a decline in forward prices. If the decline in prices is for a significant proportion of the remaining expected life of the mine, this is more likely to be an impairment indicator. It appears that forward contract prices for two years out of the three years of the mine's remaining life indicate a reduction in selling prices. Based on market information, Fill has also calculated that the three-year forecast price of coal will be 20% lower than the current spot price (Part (a) of question).

Short-term market fluctuations may not be impairment indicators if prices are expected to return to higher levels. However, despite the difficulty in making such assessments, it would appear that the mining assets should be tested for impairment.

- (c) The *Conceptual Framework* states that an entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it. An entity has the ability to direct the use of an economic resource if it has the right to deploy that economic resource in its activities. Although control of an economic resource usually arises from legal rights, it can also arise if an entity has the present ability to prevent all other parties from directing the use of it and obtaining the benefits from the economic resource. For an entity to control a resource, the economic benefits from the resource must flow to the entity instead of another party.

Although the *Conceptual Framework* gives some guidance on the definition of control, existing IFRS Standards also provide help in determining whether Fill controls the mine and therefore should account for it as a business combination:

- IFRS 10 *Consolidated Financial Statements* states that an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.
- IFRS 15 *Revenue from Contracts with Customers* lists indicators of the transfer of control of an asset to a customer. One of the indicators is that the customer has the significant risks and rewards of ownership of the asset which is basically exposure to significant variations in the amount of economic benefits.

A business combination is defined in IFRS 3 *Business Combinations* as a transaction or other event in which an acquirer obtains control of one or more businesses. A business is

further defined as 'an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income or generating other income from ordinary activities.' Thus the producing mine represents a business and Fill now owns a majority of the interest in the business.

However, this is not a business combination as Fill does not have the ability to affect decisions unless another participant agrees to vote with Fill. Although Fill will control 52% of the mine, it cannot direct the use of the economic resource unless one of the other participants agrees with an operating decision proposed by Fill and approval is given by 72% of participants. However, Fill can prevent the other parties from directing the use of the mine if the purchase goes ahead, because the other two parties cannot make an operating decision without Fill's consent. Prior to the purchase of the additional investment, the approval of decisions required agreement by 72% of the participating interests. A joint control situation existed between the entities. Following the additional purchase, there is still a joint control situation as Fill's interest does not meet the 72% threshold. Therefore, the transaction will be treated as an asset acquisition and no goodwill will arise on the acquisition.

52 Zedtech

Marking scheme

| | | | Marks | |
|------------|---------------------------|---|---|----------|
| (a) | (i) | Discussion of recognition per previous <i>Conceptual Framework</i> | 2 | |
| | | Discussion of the revised <i>Conceptual Framework</i> approach to recognition | 2 | |
| | | Comparison and contrast | <u>3</u> | |
| | (ii) | Discussion of IAS 12 recognition criteria | 2 | |
| | | Discussion of IAS 37 recognition criteria | 2 | |
| | | Discussion of recognition in business combinations | <u>2</u> | |
| | (b) | (i) | Discussion of the collectability of consideration | 2 |
| | | | Discussion of performance obligations | <u>3</u> |
| | | (ii) | Application of the above principles to: | |
| | | | Oinventory | 2 |
| InventoryX | | | 3 | |
| | Collectability assessment | <u>2</u> | | |
| | | | <u>7</u> | |
| | | | 25 | |

- (a) (i) Existing IFRS Standards did not consistently apply the recognition criteria included in the 2010 *Conceptual Framework* and thus the revised 2018 *Conceptual Framework* sets out new principles for the recognition in the financial statements. The revised 2018 *Conceptual Framework* defines recognition as the process of capturing for inclusion in the financial statements an item which meets the definition of an element. Assets and liabilities are both elements of the financial statements, along with equity, income and expenses. This approach requires recognition decisions to be made by reference to the qualitative characteristics of useful financial information.

The revised 2018 *Conceptual Framework* requires that the elements of financial statements should be recognised if it provides users of financial statements with information that is useful, ie with:

- **Relevant** information about the element
- A **faithful representation** of the element

Recognition is subject to **cost constraints**: the benefits of the information provided by recognising an element should justify the costs of recognising that element.

Recognition may not provide relevant information where it is uncertain whether an asset exists, or is separable from goodwill, or whether a liability exists and where there is only a low probability that an inflow or outflow of economic benefits will occur. Additionally, if the level of measurement uncertainty is so high that the resulting information has little relevance, then recognition should not occur. The IASB decided that the revised 2018 *Conceptual Framework* should not contain a 'probability criterion', which means that there may be recognition of assets or liabilities with a low probability of an inflow or outflow of economic benefit.

- (ii) According to IAS 12 *Income Taxes*, deferred tax liabilities are recognised for all taxable temporary differences, with three exceptions. However, deferred tax assets are only recognised to the extent that it is **probable** that taxable profit will be available against which the deductible temporary differences can be utilised. Thus, the standard applies a probability threshold to deferred tax assets but not to liabilities.

Although the 2010 *Conceptual Framework* gave the same threshold for recognition of assets and liabilities, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires the recognition of assets when they are virtually certain but for liabilities when they are probable, defined as more likely than not. IAS 37 also requires the recognition of liabilities for constructive obligations. Thus, the definition of an obligation under IAS 37 can often be broader than in other standards, for example, IAS 32 *Financial Instruments: Presentation*. IAS 37 includes a probable outflow threshold for the recognition of provisions but the recognition threshold does not apply to obligations which normally fall within the scope of IAS 37 when they are acquired as part of a business combination.

IFRS 3 *Business Combinations* requires recognition of the contingent liabilities of a subsidiary irrespective of their probability. IFRS 10 *Consolidated Financial Statements* requires recognition at fair value of contingent consideration to be received for a business which is disposed of, even if the inflow is not probable. Thus, these items are recognised under IFRS 3/IFRS 10 when they arise from a business combination, whereas they are not recognised in the normal course of business.

- (b) (i) IFRS 15 *Revenue from Contracts with Customers* states that an entity must first identify the contract with the customer and as part of that identification, the entity has to determine whether it is probable that the consideration which the entity is entitled to in exchange for the goods or services will be collected. An assessment of collectability is included as one of the criteria for determining whether a contract with a customer exists.

IFRS 15 states that the entity must identify the performance obligations in the contract. Once an entity has identified the contract with a customer, it evaluates the contractual terms and its customary business practices to identify all the promised goods or services within the contract and determine which of those promised goods or services will be treated as separate performance obligations. An entity will have to decide whether the obligations are distinct or part of a series of distinct goods and services which are substantially the same and have the same pattern of transfer to the customer. A good or service is distinct if the customer can benefit from the good or service on its own.

- (ii) Technology entities often enter into transactions involving the delivery of multiple goods and services.

As regards Oinventory, it seems that all of the individual goods and services in the contract are distinct because the entity regularly sells each element of the contract separately and is not providing the significant service of integrating the goods and services. Also, as the customer could purchase each good and service without significantly affecting the other goods and services purchased, there is no dependence upon individual elements of the service. Thus hardware, professional services and hosting services should each be accounted for as separate performance obligations.

Regarding InventoryX, the professional services are distinct because Zedtech frequently sells those services on a stand-alone basis.

However, the hardware is always sold in a combined contract with the professional and hosting services and the customer cannot use the hardware on its own. As a result, the hardware is not distinct and because the hardware is integral to the delivery of the hosted software, the hardware and hosting services should be accounted for as one performance obligation while the professional services, which are distinct, would be a separate performance obligation.

When performing the collectability assessment, Zedtech only considers the customer's ability and intention to pay the expected consideration when due. Zedtech has entered into an arrangement and does not expect to collect the full contractual amount such that the contract contains an implied price concession. Therefore, Zedtech needs to assess the collectability of the amount to which it expects to be entitled, rather than the stated contractual amount. Zedtech assesses whether collectability is probable, whether the customer has the ability and intent to pay the estimated transaction price. Zedtech will determine that the amount to which it expects to be entitled is \$2.4 million and performs the collectability assessment based on that amount, rather than the contractual price of \$3 million.

53 Kayte

Workbook references. The *Conceptual Framework* and interim financial reporting are covered in chapter 1. IAS 16 is covered in Chapter 4. IFRS 5 is covered in Chapter 13.

Top tips. Part (a) required you to discuss the probability recognition criterion in the 2010 Conceptual Framework. Don't be put off by the fact this is the 2010 Conceptual Framework, as the relevant part of it has been given in the question. The question told you which standards to discuss – make sure you address what it asks for. Part (b)(i) covered the application of IAS 16 and was demanding, indicative of what could be asked in an SBR exam on topics covered in your earlier studies.

Easy marks. There were some easy marks available in part (a) for stating the recognition criteria in the 2018 Conceptual Framework. In part (b)(ii) you should have been able to apply the IFRS 5 accounting treatment for non-current assets held for sale even if you were unfamiliar with IAS 34.

Marking scheme

| | | Marks |
|-----|---|----------|
| (a) | Inconsistent application of the probability criterion (one per example) | 3 |
| | Changes to the recognition criteria in 2018 <i>Conceptual Framework</i> | 3 |
| | | <hr/> 6 |
| (b) | (i) Vessels sold after 10 years | 5 |
| | Vessels kept for 30 years | 5 |
| | Funnels | 2 |
| | | <hr/> 12 |

| | | |
|------|---|-----------|
| (ii) | Interim follow same accounting policies as for annual financial statements | 1 |
| | Measure asset at lower of carrying amount and fair value less costs to sell | 1 |
| | 1.10.20X3: Recognise impairment loss of \$100,000 | 1 |
| | 1.12.20X4: Reverse impairment loss of \$120,000 as less than cumulative impairment losses to date of \$45,000 | 1 |
| | 31.5.20X4: Can only recognise \$330,000 of the \$430,000 increase in fair value less costs to sell (up to remaining cumulative impairment losses to date) | 1 |
| | 5.6.20X4: Recognise gain on disposal | 1 |
| | Gain on disposal is non-adjusting event after the reporting period | 1 |
| | | <u>7</u> |
| | | <u>25</u> |

(a) **Probability criterion**

Different accounting standards use different levels of probability to discuss when assets and liabilities should be recognised in the financial statements.

For example:

- Economic benefits from property, plant and equipment and intangible assets need to be **probable** to be recognised; but to be classified as held for sale, the sale has to be **highly probable**.
- Under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be **probable** to be recognised, but uncertain assets on the other hand would have to be **virtually certain** to be disclosed. This could lead to a situation where two sides of the same court case have two different accounting treatments despite the likelihood of payout being identical for both parties.
- Contingent consideration is recognised in the financial statements **regardless of the level of probability**. Rather the fair value is adjusted to reflect the level of uncertainty of the contingent consideration.

The 2018 *Conceptual Framework* requires an item to be recognised in the financial statements if:

- The item meets the definition of an **element** (asset, liability, income, expense or equity); and
- Recognition of that element provides users of the financial statements with information that is **useful**, ie with:
 - **Relevant** information about the element
 - A **faithful representation** of the element

While this will not remove the inconsistencies in recognition criteria that currently exist across IFRS Standards, it does provide a basis for the IASB to consider when developing new IFRS Standards and revising existing IFRS Standards.

Furthermore, the new criteria may mean that more assets and liabilities with a low probability of inflow or outflow of economic resources are likely to be recognised. The criteria also allow for IFRS Standards to contain recognition criteria that may be considered inconsistent, but this may be a necessary consequence of providing the most useful information.

(b) (i) **Vessels**

Vessels sold at ten years old

Kayte's estimate of the residual life of these vessels is **based on acquisition cost**. This is **unacceptable** under IAS 16 *Property, Plant and Equipment*. IAS 16 defines residual value as:

'The estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.'
(para. 6)

IAS 16 requires that property, plant and equipment must be depreciated so that its depreciable amount is allocated on a systematic basis over its useful life. Depreciable amount is the cost of an asset less its residual value. IAS 16 stipulates that the **residual value must be reviewed at least each financial year-end** and, if expectations differ from previous estimates, any change is accounted for prospectively as a change in estimate under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Kayte's model implies that the residual value of the vessels remains constant through the vessels' useful life. However, the **residual value should be adjusted**, particularly as the date of sale approaches and the residual value approaches proceeds of disposal less costs of disposal at the end of the asset's useful life.

Following IAS 16, if the residual value is greater than an asset's carrying amount, the depreciation charge is zero until such time as the residual value subsequently decreases to an amount below the asset's carrying amount. The residual value should be the value at the reporting date as if the vessel were already of the age and condition expected at the end of its useful life. Depreciable amount is affected by an increase in the residual value of an asset because of past events, but not by expectation of changes in future events, other than the expected effects of wear and tear.

The **useful life of the vessels (10 years) is shorter than the total life (30 years)** so it is the residual value at the end of the 10-year useful life that must be established.

Vessels kept for 30 years

Kayte **correctly uses a residual value for these vessels based upon the scrap value of steel**. The depreciable amount of the vessels is therefore the cost less the scrap value of steel, and the vessels should be depreciated over the 30-year period.

The engine is a significant part of the asset and should be depreciated separately over its useful life of ten years until the date of the next overhaul. The cost of the overhaul should be capitalised (a necessary overhaul is not considered a day-to-day servicing cost) and any carrying amount relating to the engine before overhaul should be derecognised. Generally, however, the depreciation of the original amount capitalised in respect of the engine will be **calculated to have a carrying amount of nil when the overhaul is undertaken**.

Funnels

The funnels should be identified as significant parts of the asset and depreciated across their useful lives of 15 years. As this has not occurred, it will be necessary to **determine what the carrying amount would have been had the funnels been initially separately identified**. The initial cost of the funnels can be determined by reference to replacement cost, and the associated depreciation charge determined using the rate for the vessel (over 30 years). There will therefore be a significant carrying amount to be written off at the time the replacement funnels are capitalised.

(ii) **Property**

IAS 34 requirement

In accordance with IAS 34 *Interim Financial Reporting*, an entity must apply the same accounting policies in its interim financial statements as in its annual financial statements. Measurements should be made on a 'year to date' basis. Kayte's interim financial statements are for the six months to 30 November 20X3.

Kayte must apply the provisions of IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations* to the valuation of the property.

Application of IFRS 5

In accordance with IFRS 5, an asset held for sale should be measured at the **lower of its carrying amount and fair value less costs to sell**. Immediately before classification of the asset 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 or IAS 38 the impairment will be treated as a revaluation decrease. **Once the asset has been classified as held for sale, any 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**.

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 applicable accounting standard, here IAS 16:

Depreciation of \$500,000 per year implies a useful life of ten years, of which eight years are remaining at 1 June 20X3. Depreciation must then be charged for the four months to 1 October 20X3, the date of classification as held for sale is calculated on the carrying amount net of the impairment loss incurred on 31 May 20X3, over the remaining useful life of eight years:

$$\frac{\$5\text{m cost} - \$1\text{m accumulated depreciation} - \$0.35\text{m impairment}}{8 - \text{year remaining useful life}} \times \frac{4}{12}$$

= \$152,083 (rounded to \$0.15 million)

So the carrying amount at 1 October 20X3 is \$5m – \$1m – \$0.35m – \$0.15m = \$3.5 million

Step 2 Classified as held for sale. Compare the carrying amount (\$3.5 million) with fair value less costs to sell (\$3.4 million). Measure at the lower of carrying amount and fair value less costs to sell, here \$3.4 million, giving an initial write-down of \$100,000. Cease depreciation.

Step 3 Determine fair value less costs to sell at the date of the interim financial statements, 1 December 20X3, here given as \$3.52 million and compare with carrying amount of \$3.4 million. This gives a gain of \$120,000.

The impairment previously recognised is: \$350,000 + \$100,000 = \$450,000. The gain of \$120,000 is less than this, and may therefore be credited to profit or loss, and the property is carried at \$3.52 million.

Step 4 On 31 May 20X4, fair value less costs to sell is \$3.95 million. The change in fair value less cost to sell is recognised but the gain recognised cannot exceed any impairment losses to date. Impairment losses to date are \$350,000 + \$100,000 – \$120,000 = \$330,000, and this is less than the change in fair value less costs to sell of \$430,000 (\$3.95m – \$3.52m). This restricted gain of \$330,000 is recognised, and the property is carried at \$3.85 million (\$3.52m + \$330,000).

54 Pensions

Workbook reference. Pensions are covered in Chapter 5.

Top tips. Part (a)(i) is very straightforward, but make sure you relate your answer to the pension schemes of Joydan. In Part (a)(ii) it is important that you have an in-depth knowledge of the differences between the two schemes rather than just a general view of the differences.

Part (b): for both of the elements in Part (b) you must ensure that you are identifying the rules which surround the issues and explaining them, in order to gain full marks you will need to make sure that you have applied the rules to the scenario in the question.

Easy marks. There are marks for straightforward bookwork that you can get even if you don't get all the calculations right.

Marking scheme

| | | | | Marks |
|-----|---------|------|---|-----------|
| (a) | Joydan | (i) | Explanation | 8 |
| | | (ii) | A scheme | 7 |
| | | | B scheme | 2 |
| (b) | William | | Provision for relocation costs | 4 |
| | | | Curtailment (past service cost) of defined benefit pension plan | 4 |
| | | | | <u>4</u> |
| | | | | <u>25</u> |

(a) Briefing note for the directors of Joydan

(i) Defined contribution plans and defined benefit plans

With **defined contribution** plans, the employer (and possibly, as here, current employees too) pay regular contributions into the plan of a given or 'defined' amount each year. The contributions are invested, and the size of the post-employment benefits paid to former employees depends on how well or how badly the plan's investments perform. If the investments perform well, the plan will be able to afford higher benefits than if the investments performed less well.

The B scheme is a defined contribution plan. The employer's liability is limited to the contributions paid.

With **defined benefit** plans, the size of the post-employment benefits is determined in advance, ie the benefits are 'defined'. The employer (and possibly, as here, current employees too) pay contributions into the plan, and the contributions are invested. The size of the contributions is set at an amount that is expected to earn enough investment returns to meet the obligation to pay the post-employment benefits. If, however, it becomes apparent that the assets in the fund are insufficient, the employer will be required to make additional contributions into the plan to make up the expected shortfall. On the other hand, if the fund's assets appear to be larger than they need to be, and in excess of what is required to pay the post-employment benefits, the employer may be allowed to take a 'contribution holiday' (ie stop paying in contributions for a while).

The **main difference** between the two types of plans lies in **who bears the risk**: if the employer bears the risk, even in a small way by guaranteeing or specifying the return, the plan is a defined benefit plan. A defined contribution scheme must give a benefit formula based solely on the amount of the contributions.

A defined benefit scheme may be created even if there is no legal obligation, if an employer has a practice of guaranteeing the benefits payable.

The A scheme is a defined benefit scheme. Joydan, the employer, guarantees a pension based on the service lives of the employees in the scheme. The company's liability is not limited to the amount of the contributions. This means that the employer bears the investment risk: if the return on the investment is not sufficient to meet the liabilities, the company will need to make good the difference.

(ii) **Accounting treatment: B scheme**

No assets or liabilities will be recognised for this defined contribution scheme, other than current liabilities to reflect amounts due to be paid to the pension scheme at year end. The **contributions** paid by the company of \$10 million will be **charged to profit or loss**. The contributions paid by the employees will not be a cost to the company but will be adjusted in calculating employee's net salary.

Accounting treatment: A scheme

The accounting treatment is as follows:

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME NOTES

Expense recognised in profit or loss for the year ended 31 October 20X7

| | \$m |
|--|-------------|
| Current service cost | 20.0 |
| Net interest on the net defined benefit liability (10 – 9.5) | 0.5 |
| Net expense | <u>20.5</u> |

Other comprehensive income: remeasurement of defined benefit plans (for the year ended 31 October 20X7)

| | \$m |
|--|--------------|
| Remeasurement gains or losses on defined benefit obligation | (29.0) |
| Remeasurement gains or losses on plan assets (excluding amounts in net interest) | <u>27.5</u> |
| | <u>(1.5)</u> |

STATEMENT OF FINANCIAL POSITION NOTES

Amounts recognised in statement of financial position

| | 31 October 20X7 | 1 November 20X6 |
|---|--------------------|--------------------|
| | \$m | \$m |
| Present value of defined benefit obligation | 240 | 200 |
| Fair value of plan assets | <u>(225)</u> | <u>(190)</u> |
| Net liability | <u>15</u> | <u>10</u> |

Change in the present value of the defined benefit obligation

| | \$m |
|--|------------|
| Present value of obligation at 1 November 20X6 | 200 |
| Interest on obligation: 5% × 200 | 10 |
| Current service cost | 20 |
| Benefits paid | (19) |
| Loss on remeasurement through OCI (balancing figure) | <u>29</u> |
| Present value of obligation at 31 October 20X7 | <u>240</u> |

Change in the fair value of plan assets

| | \$m |
|--|--------------|
| Fair value of plan assets at 1 November 20X6 | 190.0 |
| Interest on plan assets: 5% × 190 | 9.5 |
| Contributions | 17.0 |
| Benefits paid | (19.0) |
| Gain on remeasurement through OCI (balancing figure) | <u>27.5</u> |
| Fair value of plan assets at 31 October 20X7 | <u>225.0</u> |

(b) **Relocation costs and reduction to net pension liability**

A **provision for restructuring** should be recognised in respect of the relocation of the provision during the year ended 31 May 20X3 in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This is because William's board of directors authorised a **detailed formal plan** for the relocation shortly before the year end (13 May 20X3) and William has **raised a valid expectation in affected employees** that it will carry out the restructuring by informing them of the main features of the plan. As the relocation is due to take within two months of the year end (July 20X3), the time value of money is likely to be immaterial. Therefore, no discounting is required and a provision should be recognised at the estimated relocation costs of \$50 million. This assumes that the \$50 million relocation costs are only direct expenditures arising from the restructuring which are necessarily entailed by the restructuring and are not associated with the ongoing activities of William. Specifically, the restructuring provision should not include costs relating to the relocation of continuing staff.

The reduction in the net pension liability as a result of the employees being made redundant and no longer accruing pension benefits is a **curtailment** under IAS 19 *Employee Benefits*. IAS 19 defines a curtailment as occurring when an entity significantly reduces the number of employees covered by a plan. It is **treated as a type of past service costs**. The past service cost may be negative (as is the case here) when the benefits are withdrawn so that the present value of the defined benefit obligation decreases. IAS 19 requires the past service cost to be **recognised in profit or loss** at the earlier of:

- When the plan curtailment occurs; and
- When the entity recognises the related restructuring costs.

Here the restructuring costs (and corresponding provision) are recognised in the year ended 31 May 20X3 and the plan curtailment will not take place until after the year end in July 20X3 when the employees are made redundant. Therefore, the reduction in the net pension liability and corresponding income in profit or loss should be recognised at the earlier of these two dates, ie when the restructuring costs are recognised in the year ended 31 May 20X3.

Both the relocation costs and income from the reduction in the net pension liability are likely to require **separate disclosure** in the statement of profit or loss and other comprehensive income or in the notes to the accounts per IAS 1 *Presentation of Financial Statements* due to their materiality.

55 Emcee

Workbook references. IAS 38 *Intangible Assets*, IAS 23 *Borrowing Costs* and IFRS 13 *Fair Value Measurement* are covered in Chapter 4. IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* is covered in Chapter 14 and IAS 24 *Related Party Disclosures* in Chapter 2.

Top tips. This is a multi-standard question in which the three parts are independent. You should scan read all parts of the question and attempt the part you feel most comfortable with first. The issues covered are borrowing costs (Part (a)), intangible assets, non-current assets held for sale and impairment of assets (Part (b)) and fair value measurement and related party transactions (Part (c)). The recommended approach is to discuss the general principles of the relevant standards and then apply them to the scenario. Part (b) is broken down into four elements so ensure you provide an answer to each.

Easy marks. No parts of this question are particularly easy – the main way to get the marks is to break down the scenario into its constituent parts and make sure you deal with each relevant standard.

| | Marks |
|---|-----------|
| (a) Discussion of IAS 23 requirements and calculation of capitalised interest – 1 mark per point to a maximum | 6 |
| (b) Discussion of IAS 38 recognition requirements, applicability of IFRS 5 and impairment under IAS 36 – 1 mark per point to a maximum | 11 |
| (c) Discussion of IFRS 13 and IAS 24 – 1 mark per point to a maximum | 8 |
| | <u>25</u> |

(a) **Borrowing costs**

IAS 23 *Borrowing Costs* requires borrowing costs incurred on acquiring or constructing an asset to be **capitalised** if the asset takes a substantial period of time to be prepared for its intended use or sale. Borrowing costs should be capitalised during construction and include the costs of general borrowings which would have been avoided if the expenditure on the asset had not occurred. The general borrowing costs are determined by applying the weighted average of the borrowing costs applicable to the general pool

The weighted average carrying amount of the stadium during the period is:

$\$(20 + 70 + 120 + 170)m/4$, that is \$95 million.

The capitalisation rate of the borrowings of Emcee during the period of construction is 9% per annum, therefore the total amount of borrowing costs to be capitalised is the weighted average carrying amount of the stadium multiplied by the capitalisation rate.

That is $(\$95m \times 9\% \times 4/12)$ \$2.85 million.

(b) **Players' registrations**

Acquisition

IAS 38 *Intangible Assets* states that an entity should recognise an intangible asset where it is probable that future economic benefits will flow to the entity and the cost of the asset can be measured reliably. Therefore, the **costs** associated with the acquisition of players' registrations should be **capitalised at the fair value of the consideration payable**. Costs would include transfer fees, league levy fees, agents' fees incurred by the club and other directly attributable costs. Costs also **include the fair value of any contingent consideration**, which is primarily payable to the player's former club with associated league levy fees, once payment becomes probable. Subsequent reassessments of the amount of contingent consideration payable would be also included in the cost of the player's registration. The estimate of the fair value of the contingent consideration payable requires management to assess the likelihood of specific performance conditions being met, which would trigger the payment of the contingent consideration. This assessment would be carried out on an individual player basis. The additional amount of contingent consideration potentially payable, in excess of the amounts included in the cost of players' registrations, would be disclosed. Amounts capitalised would be fully amortised over the period covered by the player's contract.

Extension

Where a playing contract is extended, any **costs associated with securing the extension are added to the unamortised carrying amount** at the date of the extension and the revised carrying amount is amortised over the remaining revised contract life.

Sale of registrations

Player registrations would be classified as assets held for sale under IFRS 5 Non-Current Assets Held for Sale and Discontinued Operations when their **carrying amount is expected to be recovered principally through a sale** transaction and a sale is considered to be highly probable. Additionally, the registrations should be actively marketed by Emcee, which it appears that they are. It would appear that in these circumstances that management is committed to a plan to sell the registration, that the asset is available for immediate sale, that an active programme to locate a buyer is initiated by circulating clubs. IFRS 5 requires that it is unlikely that the plan to sell the registrations will be significantly changed or withdrawn. In order to fulfil the last criteria of IFRS 5, it may be prudent to only class these registrations as held for sale where unconditional offers have been received prior to a period end.

However, because of the subjectivity involved, in the case of player registrations these assets would be stated at the lower of the carrying amount and fair value less costs to sell, as the carrying amount will already be stated in accordance with IFRSs.

Gains and losses on disposal of players' registrations would be determined by comparing the fair value of the consideration receivable, net of any transaction costs, with the carrying amount and would be recognised in profit or loss within profit on disposal of players' registrations. Where a part of the consideration receivable is contingent on specified performance conditions, this amount is recognised in profit or loss when the conditions are met.

The player registrations disposed of, subsequent to the year end, for \$25 million, with an associated net book value of \$7 million, would be disclosed as events after the reporting date.

Impairment review

IAS 36 Impairment of Assets states that entities should annually **test their assets for impairment**. An asset is impaired if its carrying amount exceeds its recoverable amount which is the higher of the asset's fair value less costs of disposal and its value in use. It is difficult to determine the value in use of an individual player in isolation as that player (unless via a sale or insurance recovery) cannot generate cash flows on his own. Whilst any individual player cannot really be separated from the single cash-generating unit (CGU), being the basketball or football team, there may be certain circumstances where a player is taken out of the CGU, when it becomes clear that they will not play for the club again. If such circumstances arise, the **carrying amount of the player should be assessed against the best estimate of the player's fair value less any costs to sell and an impairment charge made in profit or loss**, which reflects any loss arising.

(c) **Valuation of stadiums**

IFRS 13 *Fair Value Measurement* would value the stadiums at the **price which would be received to sell the asset in an orderly transaction between market participants** at the measurement date. The price would be the one which **maximises the value of the asset** or the group of assets using the principal of the highest and best use. The price would essentially use Level 2 inputs which are inputs other than quoted market prices included within Level 1 which are observable for the asset or liability, either directly or indirectly. Property naming rights present complications when valuing property. The status of the property dictates its suitability for inviting sponsorship attached to its name. It has nothing to do with the property itself but this can be worth a significant amount. Therefore, Emcee could **include the property naming rights in the valuation** of the stadiums and write it off over three years.

IAS 24 *Related Party Disclosures* sets out the criteria for two entities to be treated as related parties. Such criteria include being members of the same group or where a person or a close member of that person's family is related to a reporting entity if that person has control or joint control over the reporting entity. IAS 24 deems that parties are not related simply because they have a director or key manager in common. In this case, there are **two directors in common** and it appears as though the **entities are not related**. However,

the regulator will need to establish whether the **sponsorship deal is a related party transaction** (RPT) for the purpose of the financial control provisions. There would need to be demonstrated that the airline may be expected to influence, or be influenced by, the club or a related party of the club. If the deal is deemed to be an RPT, the regulator will consider whether the sponsorship is at fair value.

56 Estoil

Workbook reference. Impairment is covered in Chapter 4 of your Workbook.

Top tips. IAS 36 is brought forward knowledge from earlier studies, however, in SBR the depth of discussion required is greater, and the scenario requires more thought. Part (a) required a discussion of factors to take account of in conducting an impairment test. There are five factors provided in the question and you should use these as headings under which to structure your answer. The discussion required drew on your financial management knowledge (eg WACC).

Easy marks. There are no obvious easy marks in this question.

Marking scheme

| | | Marks |
|-----|--------------------------|-----------|
| (a) | Changes in circumstances | 3 |
| | Market capitalisation | 2 |
| | Allocating goodwill | 2 |
| | Valuation issues | 6 |
| | Disclosures | <u>2</u> |
| | | 15 |
| (b) | Discount rate | 5 |
| | Cash flow forecast | <u>5</u> |
| | | 10 |
| | | <u>25</u> |

- (a) Entities must determine, **at each reporting date**, whether there are any indications that impairment has occurred. Indicators of impairment may be internal or external. The following factors need to be considered when conducting an impairment test under IAS 36 *Impairment of Assets*.

(i) **Changes in circumstances in the reporting period**

Circumstances may change due to internal factors, for example matters as physical damage, adverse changes to the methods of use of the asset, management restructuring and over-estimation of cash flows, and external factors, such as **adverse changes** in the **markets** or **business** in which the asset is used, or adverse changes to the **technological, economic or legal environment** of the business.

If such indicators come to light between the date of the impairment test and the end of the next reporting period, **more than one impairment test may be required** in the accounting period. In addition, tests for impairment of goodwill and some other intangible assets may be performed at any time during the accounting period, provided it is performed at the same time each year. Not all goodwill is tested at the year end – some entities test it at an interim period. Should impairment indicators arise after the annual impairment test has been performed, it may be necessary to test goodwill for impairment again at the year end.

A possible indicator of impairment is volatility in the market, for example, sharp changes in commodity prices may cause the assets of mining and energy companies to be impaired. In such cases, the assets affected should be tested in the interim period.

(ii) **Market capitalisation**

A strong indicator of impairment is when the **carrying amount** of an entity's assets exceeds the entity's **market capitalisation**, suggesting that the entity is overvalued. However, there **may not be a direct correlation** between the market capitalisation and the impairment loss arising from a lower return generated on the entity's assets –the market may have taken other factors into account. The discrepancy does, however, **highlight the need for the entity to examine its cash-generating units, and possibly to test goodwill for impairment**. The reason for the shortfall must be examined and understood, even though IAS 36 does not require a formal reconciliation between an entity's market capitalisation, its fair value less costs to sell and its value in use.

(iii) **Allocating goodwill to cash-generating units**

Goodwill arising on an acquisition is required to be allocated to each of the acquirer's cash-generating units (CGUs), or to a group of CGUs, that are expected to benefit from the synergies of the combination. **If CGUs are subsequently revised or operations disposed of, IAS 36 requires goodwill to be reallocated, based on relative values, to the units affected.**

The difficulty with this is that IAS 36 **does not give guidance as to what is meant by relative value**. While **fair value less costs to sell (FVLCS)** could be used, this is not mandated by the standard. However, the entity may still need to carry out a valuation process on the part retained. **Value in use (VIU)** is a possibility, but the measure needs to be one that can be applied equally to both the part retained and the part disposed of. VIU has the obvious problem that it will be much the same as FVLCS for the operations disposed of, but there could be significant differences between VIU and FVLCS for the part retained. Alternatively, there could be reasonable ways of estimating relative value by using an **appropriate industry or business surrogate**, for example revenue, profits, industry KPIs.

(iv) **Valuation issues**

The basic principle of IAS 36 is that an asset should be carried at no more than its recoverable amount, that is the amount to be recovered through use or sale of the asset. If an **asset's value is higher than its recoverable amount**, an **impairment loss** has occurred. The impairment loss should be **written off** against profit or loss for the year.

The **recoverable amount** is **defined** as the **higher of the asset's fair value less costs of disposal and the asset's value in use**. Measuring both of these requires the use of **estimates and assumptions**, some of which **may be problematic**.

- (1) **Fair value less costs of disposal** is defined as the price that would be received to sell the asset in an orderly transaction between market participants at the measurement date under current market conditions, net of costs of disposal. IAS 36 gives a 'hierarchy of evidence' for this, with 'price in a binding sale agreement' at the top, only likely to be available if the asset is held for sale, and allowing, in the absence of any active market, estimates based on **a discounted cash flow (DCF) model, which may not be reliable**.
- (2) Determining the types of **future cash flows which should be included in the measurement of VIU can also be difficult**. Under IAS 36 an asset or CGU must be tested in its current status, not the status that management wishes it was in or hopes to get it into in the near future. Therefore, the standard requires VIU to be measured at the net present value of the future cash flows the entity expects to derive from the asset or CGU in its current condition over its remaining useful life. This means that it is not appropriate to take account of management plans for enhancing the performance of the asset or CGU, even though these may bring about an increase in value.

- (3) While the cash flows used in testing for impairment are specific to the entity, the **discount rate is supposed to appropriately reflect the current market assessment of the time value of money and the risks specific to the asset or cash-generating unit**. When a specific rate for an asset or cash-generating unit is not directly available from the market, which is usually the case, the discount rate to be used is a surrogate. An estimate should be made of a **pre-tax rate that reflects the current market assessment of the time value of money and the risks specific to the asset** that have **not been adjusted** for in the estimate of future cash flows. According to IAS 36, this rate is the return that the investors would require if they chose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the assets.

Rates that should be considered are the entity's weighted average cost of capital (WACC), the entity's incremental borrowing rate or other market rates. The objective must be to obtain a rate which is sensible and justifiable.

- (4) The test is further complicated by the **impact of taxation**. IAS 36 requires that VIU be measured using pre-tax cash flows and a pre-tax discount rate, but WACC is a post-tax rate, as are most observable equity rates used by valuers.
- (5) There is a need for **consistency in determining the recoverable amount and carrying amount which are being compared**. For example, in the case of pensions, there can be significant differences between the measurement basis of the pension asset or (more likely) liability and the cash flows that relate to pensions.
- (6) IAS 36 requires that **corporate assets** must be allocated to a cash-generating unit on a 'reasonable and consistent basis, but does not expand on this.

(v) **Disclosures**

With regard to the impairment loss recognised in respect of each cash-generating unit, IAS 36 would disclose of:

- (1) The amount of the loss
- (2) The events and circumstances that led to the loss
- (3) A description of the impairment loss by class of asset

It is **no defence** to maintain that this information was **common knowledge in the market**. The disclosures are still needed.

(b) (i) **Discount rate**

Etoile has **not complied with IAS 36 Impairment of Assets** in its use of one discount rate for all cash-generating units (CGUs) regardless of the currency of the country in which the cash flows are generated. IAS 36 requires that **future cash flows must be estimated in the currency in which they will be generated** and then discounted using a discount rate appropriate for that currency. The present value thus calculated must be **translated using the spot exchange rate at the date of the value in use calculation**.

The currency in which the estimated cash flows are denominated has an impact on many of the inputs to the weighted average cost of capital (WACC) calculation, including the risk-free interest rate. **Etoile was incorrect in using the ten-year government bond rate for its own jurisdiction** as the risk-free rate because government bond rates differ between countries due to different expectations about future inflation, and so there may be a discrepancy between the expected inflation reflected in the estimated cash flows and the risk-free rate.

IAS 36 requires that the **discount rate should appropriately reflect the current market assessment of the time value of money and the risks specific to the asset or cash-generating unit**. Applying one discount rate for all the CGUs does not achieve this. The WACC of the CGU or of the company of which the CGU is currently part should generally be used to determine the discount rate. The company's WACC may only be used for all CGUs if the risks associated with the individual CGUs do not materially diverge from the remainder of the group, and this is **not evident** in the case of Etoile.

(ii) **Cash flow forecasts**

IAS 36 requires that any cash flow projections are based upon **reasonable and supportable assumptions** over a maximum period of five years unless it can be proven that longer estimates are reliable. The assumptions should **represent management's best estimate of the range of economic conditions expected to obtain over the remaining useful life of the asset**. Management must also assess the reasonableness of the assumptions by examining the reasons for any differences between past forecasted cash flows and actual cash flows. **The assumptions that form the basis for current cash flow projections must be consistent with past actual outcomes.**

Fariole has **failed to comply** with the requirements of IAS 36 in the preparation of its cash flow forecasts. Although the realised cash flow **forecasts for 20X4 were negative** and well below projected cash flows, **the directors significantly increased budgeted cash flows for 20X5**. This increase was **not justified**, and casts doubts on Fariole's ability to budget realistically.

IAS 36 requires estimates of future cash flows to include:

- (1) Projections of cash inflows from the continuing use of the asset
- (2) Projections of cash outflows which are necessarily incurred to generate the cash inflows from continuing use of the asset
- (3) Net cash flows to be received (or paid) for the disposal of the asset at the end of its useful life

Forecast cash outflows must include those relating to the day-to-day servicing of the asset. This will **include future cash outflows needed to maintain the level of economic benefits expected to be generated by the asset in its current condition**. Fariole has not taken into account expected changes in working capital and capital expenditure, but it is very likely that investments in working capital and capital expenditure would be necessary to maintain the assets of the CGUs in their current condition.

In conclusion, the **cash flow forecasts used by Fariole are not in accordance with IAS 36.**

57 Evolve

Workbook references. IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments* are covered in Chapter 8. IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* is covered in Chapter 14. IAS 16 *Property, Plant and Equipment* and IAS 40 *Investment Property* are covered in Chapter 4 and IAS 12 *Income Taxes* in Chapter 7.

Top tips. Part (a) is tricky. It asks how the potential payment of cash in the future to equity shareholders should be classified. It had to be classified as a financial liability as there was a contractual obligation to deliver cash as a result of a put option to sell the rights back to the company. An event after the reporting period provided additional evidence of the valuation and should therefore be treated as an adjusting event. Part (b) is more mainstream. The directors had not classified the assets of a subsidiary as held for sale, even though the IFRS 5 criteria were met, on the grounds that they did not have a binding agreement to sell. However, this is not required for a sale to be considered 'highly probable' under IFRS 5, and so the assets should have been classified as held for sale. Part (c) required consideration of three issues. First, a gain arising where a subsidiary which was purchased at less than the market value of its sole asset should not be treated as a bargain purchase because this treatment is only available for a business combination, and the substance of the transaction was the purchase of an asset rather than a business combination. Second, the company wishes to use the cost model, the asset should have been recorded at cost, even if this is less than market value, so the potential gain should not have been recorded in profit or loss or added to the cost of the asset. Third, the deferred tax liability arising on the difference from market value should not be capitalised as it is not linked to bringing the asset to the condition necessary for its operations,

Easy marks. There are no easy marks in this question. Marks are not as difficult to earn in Part (b), as opposed to Parts (a) or (c).

| | Marks |
|------------------------------------|-----------|
| (a) 1 mark per point up to maximum | 9 |
| (b) 1 mark per point up to maximum | 10 |
| (c) 1 mark per point up to maximum | 6 |
| | <u>25</u> |

(a) **Obligation to purchase own equity instruments**

A financial liability for the present value of the maximum amount payable to shareholders should be recognised in the financial statements as of 31 August 20X6. At 31 August 20X6, the rights are equivalent to a written put option because they represent for Evolve a purchase obligation which gives shareholders the right to sell the entity's own equity instruments for a fixed price. The fundamental principle of IAS 32 *Financial Instruments: Presentation* is that a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form, and the definitions of financial liability and equity instrument. IAS 32 states that a contract which contains an entity's obligation to purchase its own equity instruments gives rise to a financial liability, which should be recognised at the present value of its redemption amount. IAS 32 also states that a contractual obligation for an entity to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation is conditional on the counterparty exercising a right to redeem, as is the case with the scrip issue of Evolve.

Evolve had set up the conditions for the share capital increase in August 20X6 and, therefore, the contract gave rise to financial liabilities from that date and Evolve should have recognised a financial liability for the present value of the maximum amount payable to shareholders in its financial statements for the year ended 31 August 20X6. A non-adjusting event under IAS 10 *Events After the Reporting Period* is an event after the reporting period which is indicative of a condition which arose after the end of the reporting period. However, it could be argued that the transferring of the free allocation rights back to Evolve is in fact an adjusting event as it is an event after the reporting period which provides further evidence of conditions which existed at the end of the reporting period.

(b) **Classification as held for sale**

The non-current assets of Resource should have been presented as held for sale in the financial statements, in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, as at 31 August 20X6. IFRS 5 states that the appropriate level of management must be committed to a plan to sell the asset for the sale to be probable. Evolve's acceptance of a binding offer in August 20X6 and the publication of this information indicated a high probability of sale. Despite the uncertainties surrounding the sale, the transaction remained highly probable at 31 August 20X6. IFRS 5 requires an entity to classify a non-current asset as held for sale if its carrying amount will be recovered principally through sale rather than through continuing use.

IFRS 5 does not require the existence of a binding sales agreement in order to classify a non-current asset as held for sale but only a high probability of its occurrence. The acceptance of an offer by Evolve indicates that the transaction met the criteria to be classified as held for sale at 31 August 20X6. The finalisation of the agreement on 20 September 20X6 only confirmed the situation existing at 31 August 20X6. Further, Evolve cannot apply IFRS 5 measurement criteria without classifying the item as held for sale in its statement of financial position particularly as a profit or impairment may arise when using such criteria. IFRS 5 also states that immediately before the initial classification of the asset as held for sale, the carrying amount of the asset should be measured in accordance with applicable IFRSs. This was already the case as regards the non-current assets of Resource.

Other criteria which indicate that the non-current assets should be shown as held for sale include the fact that a buyer for the non-current assets has been found, the sale occurred within 12 months of classification as held for sale, the asset was actively marketed for sale at a sales price which has been accepted, and despite the uncertainties at 31 August 20X6, events after the reporting period indicate that the contract was not significantly changed or withdrawn. The fact that the information regarding the uncertainties was not publicly disclosed is irrelevant.

Thus, as the non-current assets met the criteria to be classified as held for sale, they should have been measured and presented as such in the financial statements. Assets classified as held for sale must be presented separately on the face of the statement of financial position.

(c) **Investment property**

IFRS 3 *Business Combinations* must be applied when accounting for business combinations, but does not apply where the acquisition is not of a business. In this case, the acquisition was essentially that of an asset and therefore the measurement requirements of IFRS 3 would not apply.

IAS 40 *Investment Property* states that the cost of an investment property comprises its purchase price and any directly attributable expenditure, such as professional fees for legal services. IAS 16 *Property, Plant and Equipment* states that the cost of an item of PPE comprises any cost directly attributable to bringing the asset to the condition necessary for it to be capable of operating in the manner intended by management. Hence if Evolve wishes to use the cost basis for accounting for the investment property, the potential gain should not have been recorded in profit or loss or added to the cost of the asset.

Evolve should have recognised the tax payment as an expense in the statement of profit or loss and other comprehensive income. Administrative and other general overhead costs are not costs of an item of PPE according to IAS 16. The specific fiscal treatment and the tax to be paid were not linked to bringing the asset to the condition necessary for its operations, as the asset would have been operational without the tax. As such, the tax is a cost linked to the activity of Evolve and should be accounted for as an expense in accordance with IAS 12 *Income Taxes* and included in the profit or loss for the period, unless that tax arises from a transaction recognised outside profit or loss.

58 Gasnature

Workbook references. IFRS 9 *Financial Instruments* is covered in Chapter 8, IFRS 11 *Joint Arrangements* in Chapter 15 and IAS 10 *Events after the Reporting Period* in Chapter 6.

Top tips. Part (a) is a good example of applying mainstream syllabus topics (IAS 16) to an unusual situation ('irrecoverable gas'). Part (b) on 'own use' contracts has come up before, and the case could be argued either way. There were marks available for dealing with fundamental principles of whether the contract is a financial contract or an executory contract. If the arguments seem complex, the good news is that there are only six marks for this part of the question, and you can make up the marks in Part (c), which is more mainstream.

Easy marks. Part (c) is relatively straightforward, and you should by now be familiar with the IFRS 11 criteria for distinguishing joint ventures from joint operations.

| | Marks |
|---|--------------|
| (a) 1 mark per point up to maximum | 9 |
| (b) 1 mark per point up to maximum | 6 |
| (c) (i) 1 mark per point up to maximum | 5 |
| (c) (ii) 1 mark per point up to maximum | 5 |
| | <u>25</u> |

(a) Joint arrangement

The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement (IFRS 11 *Joint Arrangements*). A joint arrangement occurs where two or more parties have joint control. The contractually agreed sharing of control of an arrangement exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. The structure and form of the arrangement determines the nature of the relationship. However, regardless of the purpose, structure or form of the arrangement, the classification of joint arrangements depends upon the parties' rights and obligations arising from the arrangement. A joint arrangement which is not structured through a separate vehicle is a joint operation. In such cases, the contractual arrangement establishes the parties' rights and obligations. A joint operator accounts for the assets, liabilities, revenues and expenses relating to its involvement in a joint operation in accordance with the relevant IFRSs. The arrangement with Gogas is a joint operation as there is no separate vehicle involved and they have agreed to share services and costs with decisions regarding the platform requiring unanimous agreement of the parties. Gasnature should recognise its share of the asset as property, plant and equipment.

Under IAS 16 *Property, Plant and Equipment* (PPE), the cost of an item of property, plant and equipment includes the initial estimate of the present value of dismantling and removing the item and restoring the site on which it is located. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* contains requirements on how to measure decommissioning, restoration and similar liabilities. Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation. Thus costs incurred by an entity in respect of obligations for dismantling, removing and restoring the site on which an item of property, plant and equipment is located are recognised and measured in accordance with IAS 16 and IAS 37. Gasnature should recognise 55% of the cost of decommissioning the underground storage facility. However, because Gasnature is a joint operator, there is also a contingent liability for 45% of the decommissioning costs and there is a possible obligation for the remainder of the costs depending on whether some uncertain future event occurs, that is Gogas goes into liquidation and cannot fund the decommissioning costs. Therefore Gasnature, should also disclose a contingent liability relating to the Gogas's share of the obligation to the extent that it is contingently liable for Gogas's share.

IAS 16 states that property, plant and equipment are tangible items which:

- (i) Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- (ii) Are expected to be used during more than one period.

Thus Gasnature should classify and account for its share of the irrecoverable gas as PPE. The irrecoverable gas is necessary for the storage facility to perform its function. It is therefore part of the storage facility and should be capitalised as a component of the storage facility asset. The irrecoverable gas should be depreciated to its residual value over the life of the storage facility. However, if the gas is recoverable in full when the storage facility is decommissioned, then depreciation will be recorded against the irrecoverable gas component only if the estimated residual value of the gas decreases below cost during the life of the facility. When the storage facility is decommissioned and the cushion gas extracted and sold, the sale of the irrecoverable gas is accounted for as the disposal of an item of PPE in accordance with IAS 16 and the gain or loss recognised in profit or loss. The natural gas in excess of the irrecoverable gas which is injected into the facility should be treated as inventory in accordance with IAS 2 *Inventories*.

(b) Contract with Agas

IFRS 9 *Financial Instruments* applies to those contracts to buy or sell a non-financial item which can be settled net in cash with the exception of contracts which are held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (own use contract). In other words, it will result in physical delivery of the commodity, in this case the extra gas. Contracts which are for an entity's 'own use' are exempt from the requirements of IFRS 9. Such a contract can be irrevocably designated as measured at fair value through profit or loss even if it was entered into for the above purpose. This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') which would otherwise arise from not recognising that contract because it is excluded from the scope of IFRS 9. There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include the following:

- (i) When the terms of the contract permit either party to settle it net in cash
- (ii) When the ability to settle net in cash is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash
- (iii) When, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery, for the purpose of generating a profit
- (iv) When the non-financial item which is the subject of the contract is readily convertible to cash

A written option to buy or sell a non-financial item which can be settled net in cash is within the scope of IFRS 9. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entities expected purchase, sale or usage requirements. Contracts to buy or sell a non-financial item, such as a commodity, which can be settled net in cash or another financial instrument, or by exchanging financial instruments, are within the scope of IFRS 9. They are accounted for as derivatives. A level of judgement will be required in this area as net settlements caused by unique events beyond management's control may not necessarily prevent the entity from applying the 'own use' exemption to all similar contracts.

The contract entered into by Gasnature with Agas seems to be an own use contract which falls outside IFRS 9 and therefore would be treated as an executory contract. However, it could be argued that the contract is net settled because the penalty mechanism requires Agas to compensate Gasnature at the current prevailing market price. Further, if natural gas is readily convertible into cash in the location where the delivery takes place, the contract could be considered net settled. Additionally, if there is volume flexibility, then the contract could be regarded as a written option, which falls within the scope of IFRS 9.

However, the contract will probably still qualify as 'own use' as long as it has been entered into and continues to be held for the expected counterparties' sales/usage requirements. Additionally, the entity has not irrevocably designated the contract as measured at fair value through profit or loss, thus adding weight to the 'own use' designation.

- (c) (i) It is not acceptable to accrue the costs of the overhaul. The entity does not have a constructive obligation to undertake the overhaul. Under IFRS, costs related to major inspection and overhaul are recognised as part of the carrying amount of property, plant and equipment if they meet the asset recognition criteria in IAS 16 *Property, Plant and Equipment*. The major overhaul component will then be depreciated on a straight-line basis over its useful life (ie over the period to the next overhaul) and any remaining carrying amount will be derecognised when the next overhaul is performed. Costs of the day-to-day servicing of the asset (ie routine maintenance) are expensed as incurred. Therefore, the cost of the overhaul should have been identified as a separate component of the refinery at initial recognition and depreciated over a period of two years. This will result in the same amount of expense being recognised in profit or loss over the same period as the proposal to create a provision.
- (ii) Since there were no indicators of impairment at the period end, all costs incurred up to 31 August 20X5 amounting to \$5 million should remain capitalised by the entity in the financial statements for the year ended on that date. However, if material, disclosure should be provided in the financial statements of the additional activity during the subsequent period which determined the exploratory drilling was unsuccessful. This represents a non-adjusting event as defined by IAS 10 *Events After the Reporting Period* as an event which is indicative of a condition which arose after the end of the reporting period. The asset of \$5 million and additional drilling costs of \$2 million incurred subsequently would be expensed in the following year's financial statements.

59 Complexity

Workbook references. Financial instruments are covered in Chapter 8.

Top tips. This is a largely discursive question relating to financial instruments, focusing on the perceived problems with accounting for financial instruments. It requires understanding of IFRS 9 and IFRS 13, as well as an awareness of current issues around financial instruments.

Easy marks. The calculation is a good source of easy marks as it is straightforward. And there are marks for bookwork – listing the problems of complexity and advantages of fair value.

Marking scheme

| | | | Marks |
|-----|------|--------------------------------|-----------|
| (a) | (i) | Identical payment | 2 |
| | | Carrying amount | 2 |
| | | Fair value | <u>2</u> |
| | | | 6 |
| | (ii) | Hedging discussion | 5 |
| | | Effectiveness discussion | <u>4</u> |
| | | | 9 |
| (b) | (i) | 1 mark per point up to maximum | 6 |
| | (ii) | 1 mark per point up to maximum | <u>4</u> |
| | | | <u>10</u> |
| | | | <u>25</u> |

- (a) (i) IFRS 9 *Financial Instruments* requires an entity to value its financial liabilities at **amortised cost** with an option to designate them as measured at **fair value through profit or loss** if it reduces or eliminates an accounting mismatch or because a group of liabilities is managed and its performance evaluated on a fair value basis. The accounting treatment applied will impact on how the initial and new loans are measured and at what carrying amount they are presented within the financial statements.

The carrying amounts under the amortised cost and fair value methods are calculated as follows:

Amortised cost

Using amortised cost, both the initial loan and the new loan result in **single payments that are almost identical** on 30 November 20X9:

Initial loan: $\$47\text{m} \times 1.05$ for 5 years = $\$59.98\text{m}$

New loan: $\$45\text{m} \times 1.074$ for 4 years = $\$59.89\text{m}$

However, the **carrying amounts at 30 November 20X5 will be different:**

Initial loan: $\$47\text{m} + (\$47\text{m} \times 0.05) = \49.35m

New loan: $\$45\text{m}$

Fair value

If the two loans were carried at fair value, both **the initial loan and the new loan would have the same carrying amount**, and be carried at $\$45$ million at 30 November 20X5. This is because both loans result in a single repayment of $\$59$ million on 30 November 20X9 and so are effectively worth the same amount. As the second loan was obtained on 30 November 20X5, the fair value of a loan with repayment of $\$59$ million on 30 November 20X9 must be the amount borrowed at the market rate on that date, ie $\$45$ million. There would be a net profit of $\$2$ million, made up of the interest expense of $\$47\text{m} \times 5\% = \2.35m and the unrealised gain of $\$49.35\text{m} - \$45\text{m} = \$4.35\text{m}$.

(ii) **Hedge accounting**

IFRS 9 *Financial Instruments* allows hedge accounting but only if **all** of the following **conditions** are met.

- (i) The hedging relationship consists **only of eligible hedging instruments and eligible hedged items**.
- (ii) There must be **formal documentation** (including identification of the hedged item, the hedging instrument, the nature of the risk that is to be hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk).
- (iii) The hedging relationship meets all of the IFRS 9 hedge effectiveness criteria.

IFRS 9 defines **hedge effectiveness** as the degree to which changes in the fair value or cash flows of the hedged item attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument. The directors of Complexity have asked whether hedge effectiveness can be calculated. IFRS 9 uses an **objective-based assessment** for hedge effectiveness, under which the following criteria must be met.

- (i) There is an **economic relationship** between the hedged item and the hedging instrument, ie the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk;

- (ii) The **effect of credit risk does not dominate the value** changes that result from that economic relationship, ie the gain or loss from credit risk does not frustrate the effect of changes in the underlying item on the value of the hedging instrument or the hedged item, even if those changes were significant; and
 - (iii) The **hedge ratio of the hedging relationship** (quantity of hedging instrument vs quantity of hedged item) is the same as that resulting from the quantity of the hedged item that the entity **actually hedges** and the quantity of the hedging instrument that the entity **actually uses** to hedge that quantity of hedged item.
- (b) (i) IFRS 9 *Financial Instruments* provides a model for the classification and measurement of financial instruments that is based on principles and the entity's underlying business model. Many users find financial instruments to be complex often due to the nature of the financial instruments themselves and the **many different ways in which they can be measured**. The measurement method depends on:
- (1) The **applicable financial reporting standard**. A variety of IFRS Standards apply to the measurement of financial instruments. For example, financial assets may be measured using consolidation for subsidiaries (IFRS 10), the equity method for associates and joint ventures (IAS 28 and IFRS 11) or IFRS 9 for most other financial assets.
 - (2) The **categorisation of the financial instrument**. IFRS 9 classifies financial assets as measured at **amortised cost, fair value through profit or loss or fair value through other comprehensive income**. A financial asset may only be classified as measured at amortised cost if the object of the business model in which it is held is to collect contracted cash flows and its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest. Financial liabilities are generally accounted for at amortised cost but may be accounted for under the fair value model as was shown in (a)(i).
 - (3) Whether **hedge accounting** has been applied. As was discussed in (a)(ii), hedge accounting is **complex**, for example when cash flow hedge accounting is used, gains and losses may be split between profit or loss for the year and other comprehensive income (items that may subsequently be reclassified to profit or loss). In addition, there may be mismatches when hedge accounting applies reflecting the underlying mismatches under the non-hedging rules.

Some measurement methods use an estimate of **current value**, and others use **historical cost**. Some include impairment losses, others do not.

The different measurement methods for financial instruments creates a number of **problems for preparers and users** of accounts:

- (1) The treatment of a particular instrument **may not be the best**, but may be determined by other factors.
- (2) Gains or losses resulting from different measurement methods may be combined in the same line item in the statement of profit or loss and other comprehensive income. **Comparability** is therefore compromised.
- (3) Comparability is also affected when it is **not clear** what measurement method has been used.
- (4) It is **difficult to apply the criteria** for deciding which instrument is to be measured in which way. As new types of instruments are created, the criteria may be applied in ways that are not consistent.

- (ii) The accountant's suggestion that information relating to financial instruments is too complex to disclose is not a good enough reason to avoid making disclosures in the financial statements. IFRS 7 *Financial Instruments: Disclosure* requires extensive disclosures that will enable the users of financial statements to better understand the quantitative effects of financial instruments (the numbers within the financial statements) and to evaluate the nature and extent of risks that arise from financial instruments and how Complexity manages those risks. That is not to say that all information relating to financial instruments needs to be disclosed and it is important that the accountant focuses on making material disclosures only.

Practice Statement 2 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. The assessment of materiality needs to be made from a quantitative perspective first and then any qualitative factors should be considered.

The reporting accountant should not view the requirements of IFRS 7 as a prescriptive list of items that must be disclosed. They must apply judgement to assess what requires disclosure and present it in a manner that will be of benefit to the users of the financial statements.

60 Carsoon

Workbook references. Leases are covered in Chapter 9, financial instruments in Chapter 8 and revenue in Chapter 3. Fair value is covered in Chapter 4.

Top tips. Allocate your time appropriately across this three-part question. The parts are independent of each other so you should scan read all parts and attempt the one you feel most comfortable with first. The key to Part (a) is to understand that Carsoon is the lessor, not the lessee and therefore the distinction between finance leases and operating leases applies. Part (b) asks you to advise on measurement issues for a financial instrument. The calculation is straightforward if you have understood the principles; if not, you would be advised to briefly state the measurement principles of IFRS 13 as far as you can and move on quickly to another part of the question. Part (c) of the question, on contractual revenue, is challenging as it gets into the specific detail of IFRS 15, but it is a topical area you should be familiar with. Ensure you breakdown your response to cover each element.

Easy marks. Part (a) contains generous marks for using the information in the question to explain how to classify Carsoon's vehicle leases in the context of IFRS 16. Parts (b) and (c) are more challenging but Part (c) contains some easy marks if you know that the general administration costs and the wasted materials costs should be expensed.

Marking scheme

| | Marks |
|---|-----------|
| (a) Classification of lease as operating lease not finance lease, accounting requirements for lease payments and assets and cash flow implications – 1 mark per point up to maximum | 9 |
| (b) Type of financial asset, IFRS 13 requirements, account for financial asset – 1 mark per point up to maximum | 8 |
| (c) Discuss each of penalties, counter claim and additional costs 1 mark per point up to maximum | 8 |
| | <u>25</u> |

- (a) Under IFRS 16 *Leases*, **Carsoon is a lessor** and must classify each lease as an operating or finance lease. A lease is classified as a finance lease if it transfers substantially all of the risks and rewards incidental to ownership of the underlying asset. All other leases are classified as operating leases. Classification is made at the inception of the lease. Whether a lease is a finance lease or an operating lease depends on the **substance of the transaction** rather than the form.

In this case, the **leases are operating leases**. The lease is unlikely to transfer ownership of the vehicle to the lessee by the end of the lease term as the option to purchase the vehicle is at a price which is higher than fair value at the end of the lease term. The lease term is not for the major part of the economic life of the asset as vehicles normally have a length of life of more than three years and the maximum unpenalised mileage is 10,000 miles per annum. Additionally, the present value of the minimum lease payments is unlikely to be substantially all of the fair value of the leased asset as the price which the customer can purchase the vehicle is above market value, hence the lessor does not appear to have received an acceptable return by the end of the lease. Carsoon also stipulates the maximum mileage and maintains the vehicles. This would appear to indicate that the risks and rewards remain with Carsoon.

Carsoon should account for the leased vehicles as property, plant and equipment (PPE) under IAS 16 *Property, Plant and Equipment* and depreciate them taking into account the expected residual value. The rental payments should go to profit or loss on a straight-line basis over the lease term. Where an item of PPE ceases to be rented and becomes held for sale, it should be transferred to inventory at its carrying amount. The proceeds from the sale of such assets should be recognised as revenue in accordance with IFRS 15 *Revenue from Contracts with Customers*.

IAS 7 *Statement of Cash Flows* states that payments from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events which enter into the determination of profit or loss. Therefore, cash receipts from the disposal of assets formerly held for rental and subsequently held for sale should be treated as cash flows from operating activities and not investing activities.

- (b) For financial assets which are debt instruments measured at fair value through other comprehensive income (FVOCI), both amortised cost and fair value information are relevant because debt instruments in this measurement category are held for both the collection of contractual cash flows and the realisation of fair values. Therefore, debt instruments measured at FVOCI are measured at **fair value** in the **statement of financial position**. In **profit or loss**, interest revenue is calculated using the **effective interest rate method**. The fair value gains and losses on these financial assets are recognised in other comprehensive income (OCI). As a result, the difference between the total change in fair value and the amounts recognised in profit or loss are shown in OCI. When these financial assets are derecognised, the cumulative gains and losses previously recognised in OCI are reclassified from equity to profit or loss. Expected credit losses (ECLs) do not reduce the carrying amount of the financial assets, which remains at fair value. Instead, an amount equal to the ECL allowance which would arise if the asset were measured at amortised cost is recognised in OCI.

The fair value of the debt instrument therefore needs to be ascertained at 28 February 20X7. IFRS 13 *Fair Value Measurement* states that Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities which the entity can access at the measurement date. In-house models are alternative pricing methods which do not rely exclusively on quoted prices. It would seem that a **Level 1 input is available**, based upon activity in the market and further that, because of the active market, there is no reason to use the in-house model to value the debt.

Therefore, the accounting for the instrument should be as follows:

Initial measurement

The bonds will be initially recorded at \$6 million and interest of \$0.24 million will be received and credited to profit or loss.

Subsequent measurement

At 28 February 20X7, the bonds will be valued at \$5.3 million, which recognises 12-month credit losses and other reductions in fair value. The loss of \$0.7 million will be charged as an impairment loss of \$0.4 million to profit or loss, representing the 12-month expected credit losses and \$0.3 million to OCI. When the bond is sold for \$5.3 million on 1 March 20X7, the financial asset is derecognised and the loss in OCI (\$0.3 million) is reclassified to profit or loss. Also, the fact that the bond is sold for \$5.3 million on 1 March 20X7 illustrates that this should have been the fair value on 28 February 20X7.

- (c) IFRS 15 *Revenue from Contracts with Customers* specifies how to account for costs incurred in fulfilling a contract which are not in the scope of another standard. Costs to fulfil a contract which is accounted for under IFRS 15 are divided into those which give rise to an asset and those which are expensed as incurred. Entities will recognise an asset when costs incurred to fulfil a contract meet certain criteria, one of which is that the costs are expected to be recovered.

For costs to meet the 'expected to be recovered' criterion, they need to be either explicitly reimbursable under the contract or reflected through the pricing of the contract and recoverable through the margin.

The penalty and additional costs attributable to the contract should be considered when they occur and Carsoon should have included them in the total costs of the contract in the period in which they had been notified.

As regards the counter claim for compensation, Carsoon accounts for the claim as a contract modification in accordance with IFRS 15. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, Carsoon should account for the modification by updating the transaction price and the measure of progress towards complete satisfaction of the performance obligation. However, on the basis of information available, it is possible to consider that the counter claim had not reached an advanced stage, so that claims submitted to the client should not be included in total revenues.

When the contract is modified for the construction of the storage facility, an additional \$7 million is added to the consideration which Carsoon will receive. The additional \$7 million reflects the stand-alone selling price of the contract modification. The construction of the separate storage facility is a distinct performance obligation and the contract modification for the additional storage facility is accounted for as a new contract which does not affect the accounting for the existing contract. Therefore, the contract is a performance obligation which has been satisfied as assets are only recognised in relation to satisfying future performance obligations. General and administrative costs cannot be capitalised unless these costs are specifically chargeable to the customer under the contract. Similarly, wasted material costs are expensed where they are not chargeable to the customer. Therefore, a total expense of \$15 million will be charged to profit or loss and not shown as assets.

61 Leigh

Workbook reference. Share-based payments are covered in Chapter 10. Associates are covered in Chapter 11.

Top tips. This was a difficult question which dealt with several share-based payment transactions. However, not all such transactions were dealt with by a single accounting standard. Part (a) dealt with the cost of a business combination and the issue of shares as purchase consideration. It also dealt with shares given to employees as remuneration. The events are dealt with under the separate accounting standards IFRS 2 and IFRS 3. Part (b) dealt with the purchase of property, plant and equipment, and the grant of rights to a director when there is a choice of settlement. This part of the question was quite technically demanding. Part (c) dealt with the issue of shares to acquire an associate and the subsequent accounting for the associate.

Easy marks. It is difficult to identify easy marks for this question.

| | Marks |
|-----------------------------------|-----------|
| (a) Hash | 7 |
| Employees | 3 |
| (b) Property, plant and equipment | 5 |
| Director | 4 |
| (c) Handy | 6 |
| | <u>25</u> |

(a) **Shares issued to the directors**

The 3 million \$1 shares issued to the directors on 1 June 20X6 as part of the **purchase consideration** for Hash are accounted for under **IFRS 3 Business Combinations** rather than under IFRS 2 *Share-based Payment*. This is because they are not remuneration or compensation, but simply part of the purchase price of the company. The cost of the business combination will be the total of the fair values of the consideration given by Leigh plus any attributable costs. The total fair value here is \$6 million, of which \$3 million is share capital and \$3 million is share premium.

The **contingent consideration** – 5,000 shares per director to be received on 31 May 20X7 if the directors are still employed by Leigh – may, however, be seen as compensation and thus fall to be treated under IFRS 2. The fact that the additional payment of shares is **linked to continuing employment** suggests that it is a compensation arrangement, and therefore **IFRS 2 will apply**.

Under IFRS 2, the fair value used is that at the **grant date**, rather than when the shares vest. The market value of each share at that date is \$2. (Three million shares are valued at \$6 million.) So the total value of the compensation is $5 \times 5,000 \times \$2 = \$50,000$.

The \$50,000 is charged to profit or loss with a corresponding increase in equity.

Shares issued to employees

These shares are remuneration and are **accounted for under IFRS 2**.

The fair value used is that at the **date of issue**, as the grant date and issue date are the same, **that is, \$3 per share**. Because the shares are given as a bonus they vest immediately and are presumed to be consideration for past services.

The total of \$3 million would be charged to profit or loss and included in equity.

(b) **Purchase of property, plant and equipment**

Under IFRS 2, the purchase of property, plant and equipment would be treated as a share-based payment in which the counterparty has a **choice of settlement**, in shares or in cash. Such transactions are **treated as cash-settled** to the extent that the entity has incurred a **liability**. It is treated as the issue of a compound financial instrument, with a debt and an equity element.

Similar to IAS 32 *Financial Instruments: Presentation*, IFRS 2 requires the **determination of the liability element and the equity element**. The fair value of the equity element is the fair value of the goods or services (in this case the property) less the fair value of the debt element of the instrument. The fair value of the property is \$4 million (per question). The share price of \$3.50 is the expected share price in three months' time (assuming cash settlement). The fair value of the liability component at 31 May 20X7 is its present value: $1.3 \text{ million} \times \$3 = \$3.9\text{m}$.

The journal entries are:

| | | | |
|--------|-------------------------------|------|--------|
| Debit | Property, plant and equipment | \$4m | |
| Credit | Liability | | \$3.9m |
| Credit | Equity | | \$0.1m |

In three months' time, the debt component is remeasured to its fair value. Assuming the estimate of the future share price was correct at \$3.50, the liability at that date will be $1.3 \text{ million} \times \$3.5 = \$4.55\text{m}$. An adjustment must be made as follows:

| | | | |
|--------|--------------------------|---------|---------|
| Debit | Expense ($4.55 - 3.9$) | \$0.65m | |
| Credit | Liability | | \$0.65m |

Choice of share or cash settlement

The share-based payment to the new director, which offers a choice of cash or share settlement, is also treated as the issue of a compound instrument. In this case, the **fair value of the services is determined by the fair value of the equity instruments given**.

The fair value of the equity alternative is $\$2.50 \times 50,000 = \$125,000$. The cash alternative is valued at $40,000 \times \$3 = \$120,000$. The **difference** between these two values – \$5,000 – is deemed to be the **fair value of the equity component**. At the settlement date, the liability element would be measured at fair value and the method of settlement chosen by the director would determine the final accounting treatment.

At 31 May 20X7, the accounting entries would be:

| | | | |
|--------|--|-----------|-----------|
| Debit | Profit or loss – directors' remuneration | \$125,000 | |
| Credit | Liability | | \$120,000 |
| Credit | Equity | | \$5,000 |

In effect, the director surrenders the right to \$120,000 cash in order to obtain equity worth \$125,000.

(c) Investment in Hardy

The investment in Hardy should be treated as an **associate under IAS 28 Investments in Associates and Joint Ventures**. Between 20% and 50% of the share capital has been acquired, and significant influence may be exercised through the right to appoint directors. Associates are accounted for as cost plus post acquisition change in net assets, **generally cost plus share of post-acquisition retained earnings**. The cost is the fair value of the shares in Leigh exchanged for the shares of Hardy. However, negative goodwill arises because the fair value of the net assets of Hardy exceeds this. The negative goodwill must be added back to determine the cost to be used for the carrying amount, and, following a reassessment, credited to profit or loss (Dr Cost 0.2, Cr P/L 0.2).

| | |
|---|------------|
| | \$m |
| Cost: $1\text{m} \times \$2.50$ | 2.5 |
| Add back negative goodwill: $(2.5 + (9 \times 70\% \text{ 'NCI')}) - 9$ | <u>0.2</u> |
| | 2.7 |
| Post-acquisition profits: $(5 - 4) \times 30\%$ | <u>0.3</u> |
| Carrying amount at 31 May 20X7 | <u>3.0</u> |

Note. The 0.2 is not part of post-acquisition retained earnings. It is adjustment to the original cost to remove the negative goodwill.

Because negative goodwill has arisen, the investment must be **impairment tested**. A comparison must be made with the estimated recoverable amount of Hardy's net assets. The investment must not be carried above the recoverable amount:

Recoverable amount at 31 May 20X7: $\$11\text{m} \times 30\% = \3.3m

The recoverable amount is above the carrying amount, so the investment at 31 May 20X7 will be shown at \$3 million.

62 Mehran

Workbook references. IFRS 13 is covered in Chapter 4. IFRS 9 is covered in Chapter 8.

Top tips. Most of this question is on IFRS 13 *Fair Value Measurement*. As well as the fair value hierarchy, it is important to be familiar the principles behind the standard, particularly the 'highest and best use' principle, and that of the 'principal and most advantageous market'. You are expected to understand the nature of the valuation hierarchy and not just quote the requirements. Although financial instruments can be tricky, you can use a similar thought process to more common items; for examples, if a fair valuation were to be placed on a motor car, the market prices for a similar car would be used and adjusted if the mileage on the car was significantly different. The same principle applies to shares.

Easy marks. Working out the most advantageous market is quite straightforward. The numbers are given to you for a reason!

Marking scheme

| | Marks |
|------------------------------------|-----------|
| (a) 1 mark per point up to maximum | 7 |
| (b) 1 mark per point up to maximum | 10 |
| (c) 1 mark per point up to maximum | 8 |
| Maximum | <u>25</u> |

(a) Land and brand name

IFRS 13 *Fair Value Measurement* requires the fair value of a non-financial asset to be measured based on its highest and best use from a market participant's perspective. This requirement does not apply to financial instruments, liabilities or equity. The highest and best use takes into account the use of the asset which is physically possible, legally permissible and financially feasible. The highest and best use of a non-financial asset is determined by reference to its use and not its classification and is determined from the perspective of market participants. It does not matter whether the entity intends to use the asset differently. IFRS 13 allows management to presume that the current use of an asset is the highest and best use unless market or other factors suggest otherwise.

In this case, the agricultural land appears to have an alternative use as market participants have considered its use for residential purposes. If the land zoned for agricultural use is currently used for farming, the fair value should reflect the cost structure to continue operating the land for farming, including any tax credits which could be realised by market participants. Thus, the fair value of the land if used for farming would be $\$(5 + (20\% \text{ of } 0.5))$ million, ie \$5.1 million.

If used for residential purposes, the value should include all costs associated with changing the land to the market participant's intended use. In addition, demolition and other costs associated with preparing the land for a different use should be included in the valuation. These costs would include the uncertainty related to whether the approval needed for changing the usage would be obtained, because market participants would take that into account when pricing value of the land if it had a different use. Thus, the fair value of the land if used for residential purposes would be $\$(7.4 - 0.2 - 0.3 - 0.1)$ million $\times 80\%$, ie \$5.44 million. Therefore, the value of the land would be \$5.44 million on the highest and best use basis. In this situation, the presumption that the current use is the highest and best use of the land has been overridden by the market factors which indicate that residential development is the highest and best use. A use of an asset need not be legal at the measurement date, but it must not be legally prohibited in the jurisdiction.

In the absence of any evidence to the contrary, Mehran should value the brand on the basis of the highest and best use. The fair value is determined from the perspective of a market participant and is not influenced by the Mehran's decision to discontinue the brand. Therefore, the fair value of the brand is \$17 million.

(b) **Fair value of inventory**

IFRS 13 sets out the concepts of principal market and most advantageous market. Transactions take place in either the principal market, which is the market with the greatest volume and level of activity for the inventory, or in the absence of a principal market, the most advantageous market. The most advantageous market is the market which maximises the amount which would be received to sell the inventory, after taking into account transaction costs and transportation costs. The price used to measure the inventory's fair value is not adjusted for transaction costs although it is adjusted for transport costs. The principal market is not necessarily the market with the greatest volume of activity for the particular reporting entity. The principle is based upon the importance of the market from the participant's perspective. However, the principal market is presumed to be the market in which the reporting entity transacts, unless there is evidence to the contrary. In evaluating the principal or most advantageous markets, IFRS 13 restricts the eligible markets to only those which can be accessed at the measurement date. If there is a principal market for the asset or liability, IFRS 13 states that fair value should be based on the price in that market, even if the price in a different market is higher. It is only in the absence of the principal market that the most advantageous market should be used. An entity does not have to undertake an exhaustive search of all possible markets in order to identify the principal or most advantageous market. It should take into account all information which is readily available.

There is a presumption in the standard that the market in which the entity normally transacts to sell the asset or transfer the liability is the principal or most advantageous market unless there is evidence to the contrary.

In this case, the greatest volume of transactions is conducted in the domestic market – direct to manufacturers. There is no problem with obtaining data from trade journals but the problem for Mehran is that there is no data to substantiate the volume of activity in the domestic market – direct to retailers even though Mehran feels that it is at least 20,000 tonnes per annum. The most advantageous market is the export market where after transport and transaction costs the price per tonne is \$1,094.

| | <i>Domestic market – direct to retailers</i> | <i>Domestic market – direct to manufacturers</i> | <i>Export market</i> |
|--------------------------------|--|--|----------------------|
| | \$ | \$ | \$ |
| Price per tonne | 1,000 | 800 | 1,200 |
| Transport costs per tonne | 50 | 70 | 100 |
| Selling agents' fees per tonne | – | 4 | 6 |
| Net price per tonne | <u>950</u> | <u>726</u> | <u>1,094</u> |

It is difficult to determine a principal market because of the lack of information. It could be argued that the domestic market – direct to manufacturers has the highest volume for the produce, and is therefore the principal market by which Mehran should determine fair value of \$730 (\$800 – \$70). However, because of the lack of information surrounding the domestic market – direct to retailers, the principal or most advantageous market will be presumed to be the market in which Mehran would normally enter into transactions which would be the export market. Therefore, the fair value would be \$1,100 (\$1,200 – \$100) per tonne.

(c) **Investment in Erham**

Measuring the fair value of individual unquoted equity instruments which constitute a non-controlling interest in a private company falls within the scope of IFRS 9 *Financial Instruments* in accordance with the principles set out in IFRS 13. There is a range of commonly used valuation techniques for measuring the fair value of unquoted equity instruments and income approaches as well as the adjusted net asset method are acceptable. IFRS 13 states that fair value is a market-based measurement, although it acknowledges that in some cases observable market transactions or other market information might not be available. IFRS 13 does not contain a hierarchy of valuation techniques nor does it prescribe the use of a specific valuation technique for meeting the objective of a fair value measurement. However, IFRS 13 acknowledges that, given specific circumstances, one valuation technique might be more appropriate than another. The market approach takes a transaction price paid for an identical or a similar instrument in an investee and adjusts the resultant valuation. The transaction price paid recently for an investment in an equity instrument in an investee which is similar, but not identical, to an investor's unquoted equity instrument in the same investee would be a reasonable starting point for estimating the fair value of the unquoted equity instrument.

Mehran would take the transaction price for the preferred shares and adjust it to reflect certain differences between the preferred shares and the ordinary shares. There would be an adjustment to reflect the priority of the preferred shares upon liquidation.

Mehran should acknowledge the benefit associated with control. This adjustment relates to the fact that Mehran's individual ordinary shares represent a non-controlling interest whereas the preferred shares issued reflect a controlling interest. There will be an adjustment for the lack of liquidity of the investment which reflects the lesser ability of the ordinary shareholder to initiate a sale of Erham relative to the preferred shareholder. Further, there will be an adjustment for the cumulative dividend entitlement of the preferred shares. This would be calculated as the present value of the expected future dividend receipts on the preferred shares, less the present value of any expected dividend receipts on the ordinary shares. The discount rate used should be consistent with the uncertainties associated with the relevant dividend streams.

Mehran should review the circumstances of the issue of the preferred shares to ensure that its price was a valid benchmark. Mehran must, however, use all information about the performance and operations of Erham which becomes reasonably available to it after the date of initial recognition of the ordinary shares up to the measurement date. Such information can have an effect on the fair value of the unquoted equity instrument at 31 March 20X6. In addition, Mehran should consider the existence of factors such as whether the environment in which Erham operates is dynamic, or whether there have been changes in market conditions between the issue of the preferred shares and the measurement date.

63 Ethan

Workbook references. Deferred tax is covered in Chapter 7. Investment property, impairment and fair value are covered in Chapter 4, and financial instruments in Chapter 8.

Top tips. In Part (a), you should focus on IFRS 13. Part (b) required application of the fair value option in IFRS 9 *Financial Instruments*. The option is used where such application would eliminate or significantly reduce a measurement or recognition inconsistency between the debt liabilities and the investment properties to which they were related in this question. In Part (c), candidates needed to recognise that, in classifying the B shares as equity rather than as a liability, the entity had not complied with IAS 32 *Financial Instruments: Presentation*. There were pointers to the shares being classified as a liability, in particular the fact that entity was obliged to pay an annual cumulative dividend on the B shares and did not have discretion over the distribution of such dividend.

Easy marks. There are no obviously easy marks in this question.

| | Marks |
|---|-----------|
| (a) Fair value of investment properties | 13 |
| (b) Fair value option – IFRS 9 | 7 |
| (c) B shares of subsidiary | 5 |
| | <u>25</u> |

(a) **Fair value of investment properties**

The **fair value** of an asset 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 (IFRS 13 *Fair Value Measurement*). IFRS 13 states that 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 three-level hierarchy for the inputs that valuation techniques use to measure fair value.

- Level 1 Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date
- Level 2 Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, eg quoted prices for similar assets in active markets or for identical or similar assets in non-active markets or use of quoted interest rates for valuation purposes
- Level 3 Unobservable inputs for the asset or liability, ie using the entity's own assumptions about market exit value

Although an active market exists for Ethan's investment properties, Ethan uses a discounted cash flow model to measure fair value. This is **not in accordance with IFRS 13**. As the fair value hierarchy suggests, IFRS 13 favours Level 1 inputs, that is market-based measures, over unobservable (Level 3) inputs such as discounted cash flows.

Goodwill and deferred tax

If the **fair value** of the investment properties is **not measured correctly** in accordance with IFRS 13, this means that the **deferred tax liability** on investment properties **may also be incorrect**. In addition, as goodwill is calculated as consideration transferred less fair value of net assets, **goodwill may be incorrect**. This is because deferred tax is calculated on the difference between the carrying amount of the asset and its tax base. So if the carrying amount is incorrect, the deferred tax will be incorrect. The goodwill calculation uses the fair value of **all** net assets, not just the investment properties and the related deferred tax liability, so it is **incorrect to use an increase in the deferred tax liability** as the **basis** for assessing whether goodwill is impaired.

The reasoning behind Ethan's approach is that as the deferred tax liability decreases, the fair value of net assets increases, thereby decreasing goodwill. However, this method of determining whether goodwill is impaired **does not accord with IAS 36 Impairment of Assets**. IAS 36 requires that goodwill should be **reviewed for impairment annually** for any indicators of impairment, which may be internal or external, and are not confined to changes in the deferred tax liability. Where it is not possible to measure impairment for individual assets, the loss should be measured for a **cash-generating unit**.

The **recoverable amount** is **defined** as the **higher** of:

- (i) The **asset's fair value less costs to sell**. This is the price that would be received to sell the asset in an orderly transaction between market participants at the measurement date under current market conditions, net of costs of disposal.
- (ii) The asset's **value in use**. This is the present value of estimated future cash flows (inflows minus outflows) generated by the asset, including its estimated net disposal value (if any) at the end of its useful life.

If an **asset's carrying amount** is **higher than its recoverable amount**, an **impairment loss** has occurred. The impairment loss should be **written off against profit or loss** for the year, and the corresponding credit (write-off) applied first to goodwill, then to the investment properties, then to other assets pro-rata.

Deferred tax assets on losses

In theory, unused tax losses give rise to a deferred tax asset. However, IAS 12 *Income Taxes* states that **deferred tax assets should only be recognised to the extent that they are regarded as recoverable**. They should be regarded as recoverable to the extent that on the basis of all the evidence available it is **probable that there will be suitable taxable profits against which the losses can be recovered**. It is unlikely that future taxable profits of Ethan will be sufficient to realise all of the tax loss because of:

- (i) The announcement that a substantial loss will be incurred this year instead of the expected profit
- (ii) Considerable negative variances against budgets in the past

Consequently, **Ethan should not recognise the deferred tax asset**.

(b) IFRS 9 fair value option

Generally under IFRS 9 *Financial Instruments*, the debt issued to finance its investment properties would be accounted for using **amortised cost**, while the properties themselves are at fair value. This is an **accounting mismatch**, that is a recognition or measurement inconsistency between the debt liability and the asset to which it relates. The asset and liability, and the gains and losses arising on them, would be measured on different bases.

The IFRS 9 **fair value option** allows an entity to **designate a liability at initial recognition as being at fair value through profit or loss** if using this option would **eliminate or significantly reduce** an accounting mismatch. Ethan has argued that the basis of measurement of the debt and the investment properties is **similar**, particularly as regards **interest rates**. This argument holds good in respect of the interest, and so the **fair value option would be allowed**.

However, IFRS 9 stipulates that if a liability is designated as being at fair value through profit or loss, **changes in the fair value that are due to changes in the liability's credit risk must be recognised directly in other comprehensive income** rather than profit or loss. Such **changes may not be re-classified** to profit or loss in subsequent years, although a **reserves transfer** is permitted from other components of equity to retained earnings. On the other hand, if **changes in the fair value attributable to the credit risk of the liability create or enlarge an accounting mismatch in profit or loss**, then all fair value movements are **recognised in profit or loss**.

(c) B shares of subsidiary

Ethan's accounting treatment of the B shares (as equity instruments) does not comply with IAS 32 *Financial Instruments: Presentation*. The IAS 32 definition of a financial liability includes any liability that is **a contractual obligation to deliver cash or another financial asset to another entity**. A financial instrument may only be classified as an equity instrument rather than a liability if the instrument does not include an obligation to deliver cash or other financial asset to another entity, or to exchange financial instruments with another entity under conditions that are potentially unfavourable.

In the **subsidiary's books**, the B shares would be treated as a **financial liability**. They contain an **obligation** to deliver cash in the form of a fixed dividend. The dividend is cumulative and must be paid whether or not the subsidiary has sufficient legally distributable profits when it is due, and so **the subsidiary cannot avoid this obligation**.

In the **consolidated financial statements**, the B shares would also be treated as a financial liability, **the intragroup element of this liability (70%) would cancel against the investment in B shares in the parent's (Ethan's) statement of financial position**. The shares **owned by external parties would not cancel**; they would remain a **financial liability**. It is **incorrect to treat them as non-controlling interest** because they are **not equity**.

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Workbook reference. Small and medium-sized entities are covered in Chapter 18 of your Workbook.

Top tips. Part (a) on the main differences between the IFRS for SMEs and full IFRS was reasonably straightforward. Part (b) required you to apply the standard to specific areas: goodwill, research and development expenditure, investment property and impairment. Remember not to use full IFRS!

Easy marks. This was a rich source of easy marks for the well-prepared candidate. Make sure your arguments are well-structured in order to earn those two marks for clarity and quality of discussion.

Marking scheme

| | Marks |
|--|-----------|
| (a) Subjective assessment including professional | 11 |
| (b) (i) Business combination | 4 |
| (ii) Research and development expenditure | 3 |
| (iii) Investment property | 2 |
| (iv) Intangible | 2 |
| | <u>22</u> |

(a) Modifications to reduce the burden of reporting for SMEs

The IFRS for SMEs has **simplifications** that reflect the needs of users of SMEs' financial statements and cost-benefit considerations. It is designed to facilitate financial reporting by small and medium-sized entities in a number of ways:

- (i) It provides significantly **less guidance** than full IFRS. A great deal of the guidance in full IFRS would not be relevant to the needs of smaller entities.
- (ii) Many of the **principles** for recognising and measuring assets, liabilities, income and expenses in full IFRSs are **simplified**. For example, goodwill and intangibles are always amortised over their estimated useful life (or ten years if it cannot be estimated). Research and development costs must be expensed. With defined benefit pension plans, all actuarial gains and losses are to be recognised immediately in other comprehensive income. All past service costs are to be recognised immediately in profit or loss. To measure the defined benefit obligation, the projected unit credit method must be used.

- (iii) Where full IFRSs allow accounting policy choices, the IFRS for SMEs **allows only the easier option**. Examples of alternatives not allowed in the IFRS for SMEs include: revaluation model for intangible assets and property, plant and equipment, proportionate consolidation for investments in jointly-controlled entities and choice between cost and fair value models for investment property (measurement depends on the circumstances).
- (iv) **Topics not relevant** to SMEs are **omitted**: earnings per share, interim financial reporting, segment reporting, insurance and assets held for sale.
- (v) Significantly **fewer disclosures** are required.
- (vi) The standard has been written in **clear language** that can easily be translated.

The above represents a considerable reduction in reporting requirements – perhaps as much as 90% – compared with listed entities. Entities will naturally wish to use the IFRS for SMEs if they can, but **its use is restricted**.

The restrictions are **not related to size**. There are several disadvantages of basing the definition on size limits alone. Size limits are **arbitrary** and **different limits are likely to be appropriate in different countries**. Most people believe that SMEs are **not simply smaller versions of listed entities**, but differ from them in more fundamental ways.

The most important way in which SMEs differ from other entities is that they are **not usually publicly accountable**. Accordingly, there are **no quantitative thresholds** for qualification as a SME; instead, the scope of the IFRS is determined by a **test of public accountability**. The IFRS is suitable for all entities except those whose securities are publicly traded and financial institutions such as banks and insurance companies.

Another way in which the use of the IFRS for SMEs is restricted is that **users cannot cherry pick** from this IFRS and full IFRS. If an entity adopts the IFRS for SMEs, it **must adopt it in its entirety**.

(b) (i) **Business combination**

IFRS 3 *Business Combinations* allows an entity to measure non-controlling interests at acquisition at either fair value or at the proportionate share of the acquiree's net assets. The IFRS for SMEs **only allows non-controlling interests to be measured at the proportionate share of the acquiree's net assets**. This avoids the need for SMEs to determine the fair value of the non-controlling interests when undertaking a business combination.

In addition, IFRS 3 requires goodwill to be tested annually for impairment. The IFRS for SMEs **requires goodwill to be amortised instead**. This is a much simpler approach and the IFRS for SMEs specifies that if an entity is unable to make a reliable estimate of the useful life, it is presumed to be ten years, simplifying things even further.

Goodwill on Whitebirk's acquisition of Close will be calculated as:

| | |
|---|----------------|
| | \$'000 |
| Consideration transferred | 5,700 |
| Non-controlling interest: 10% × \$6m | 600 |
| | <u>6,300</u> |
| Less fair value of identifiable net assets acquired | <u>(6,000)</u> |
| Goodwill | <u>300</u> |

This goodwill of \$0.3 million will be amortised over ten years, that is \$30,000 per annum.

(ii) **Research and development expenditure**

The IFRS for SMEs requires all internally generated research and development expenditure to be **expensed through profit or loss**. This is simpler than full IFRS – IAS 38 *Intangible Assets* requires internally generated assets to be capitalised if certain criteria (proving future economic benefits) are met, and it is often difficult to determine whether or not they have been met.

Whitebirk's total expenditure on research (\$0.5m) and development (\$1m) must be written off to profit or loss for the year, giving a charge of \$1.5 million.

(iii) **Investment property**

Investment properties must be held at fair value through profit or loss under the IFRS for SMEs where their fair value can be measured without undue cost or effort, which appears to be the case here, given that an estate agent valuation is available. Consequently, a gain of \$0.2 million (\$1.9m – \$1.7m) will be reported in Whitebirk's profit or loss for the year.

(iv) **Intangible asset**

IAS 36 *Impairment of Assets* requires annual impairment tests for indefinite life intangibles, intangibles not yet available for use and goodwill. This is a complex, time-consuming and expensive test.

The IFRS for SMEs only requires impairment tests where there are indicators of impairment. In the case of Whitebirk's intangible, there are no indicators of impairment, and so an impairment test is not required.

In addition, IAS 38 *Intangible Assets* does not require intangible assets with an indefinite useful life to be amortised. In contrast, under the IFRS for SMEs, all intangible assets must be amortised. If the useful life cannot be established reliably, it must not exceed ten years.

65 Revenue recognition

Workbook references. Revenue recognition is covered in Chapter 3 and provisions are covered in Chapter 6.

Top tips. This question mainly covered the accounting treatment for revenue given in IFRS 15 *Revenue from Contracts with Customers*. In part (a) Premier Co has issued two warranties, the 'standard' warranty should be accounted for under IAS 37 as a provision. However, the additional warranty is a separate performance obligation (as it offers an additional service to the customer that is usually paid for) and is therefore accounted for under IFRS 15. In part (b), Rodia Co appears to have entered into a consignment arrangement with Jae Co. In part (c), the customer has a right of return, as such Kracker Co must only recognise revenue related to items it does not expect to be returned and must recognise a refund liability and an asset in relation to the items expected to be returned. In part (d), Kotta Co must assess whether the non-refundable up-front fee relates to the transfer of a promised good or service, if so, then it is a separate performance obligation. However, in this case it appears that the actions associated with the fee are administrative in nature, and therefore are not a separate performance obligation. The fee should therefore be recognised as the access to the food store is provided.

Remember that in SBR, the situations presented will rarely be straightforward, the examiner is looking for you to present a discussion: draw out the relevant principles from the Standard and then apply them to the scenario to identify the most appropriate accounting treatment.

| | Marks |
|-----------------------------|--------------|
| (a) Warranties | 10 |
| (b) Consignment arrangement | 7 |
| (c) Right of return | 4 |
| (d) Non-refundable fee | <u>4</u> |
| | <u>25</u> |

(a) Warranties

Standard warranty

The warranty that provides assurance that the machine complies with agreed-upon specifications and will operate as promised one year from the date of purchase is a standard warranty at no cost to the customer.

Therefore, it should be accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Premier Co should recognise a provision if there is a present obligation as a result of a past event and the amount can be measured reliably.

Premier Co has a present obligation as a result of providing a warranty with each sale of the machine. The probability of paying out on an individual warranty will likely be low. However, Premier Co should consider all standard warranties provided for this machine together as they are similar obligations. When considered together, it may mean the probability of payout becomes more likely than not.

Premier Co can use an expected value approach to reliably estimate the amount of the provision.

Additional warranty

IFRS 15 *Revenue from Contracts with Customers* specifies that if the customer has the option to purchase a warranty separately, the warranty is a distinct service and should be accounted for as a separate performance obligation. In this case, the additional warranty has been given as an incentive to a new customer. As the customer would usually have the option to purchase the warranty separately for \$4,000, it should be treated as a separate performance obligation.

Sale of the machine

There are two performance obligations: the sale of the machine and the provision of the extended warranty service. The transaction price of \$196,000 should be allocated to the two performance obligations in accordance with their standalone selling prices:

| <i>Performance obligation</i> | <i>Stand-alone selling price</i> | <i>% of total</i> | <i>Transaction price allocated</i> |
|-------------------------------|----------------------------------|-------------------|------------------------------------|
| | \$ | | \$ |
| Machine | 196,000 | 98% | 192,080 |
| Extended warranty | 4,000 | 2% | 3,920 |
| Total | 200,000 | 100 | 196,000 |

Revenue of \$192,080 from the sale of the machine should be recognised when control of the machine is transferred to the customer, which is likely to be on delivery. Revenue of \$3,920 should be recognised over the period in which the service related to the extended warranty is provided. On sale of the machine, a contract liability of \$3,920 should be recognised in relation to the extended warranty.

(b) **Consignment arrangement**

This transaction appears to be a consignment arrangement. Per IFRS 15, a consignment arrangement exists when a product is delivered to another party for sale to end customers, but the other party does not obtain control of the product.

IFRS 15 includes the following indicators that an arrangement is a consignment arrangement between an entity and a dealer:

- (i) The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer or until a specified period expires;
- (ii) The entity is able to require the return of the product or transfer the product to a third party (such as another dealer); and
- (iii) The dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

In this case, the jewellery must be returned to Rodia Co after nine months if it is not sold, but it is not clear whether Rodia Co can require the jewellery to be returned at a date earlier than that. Jae Co does not have an unconditional obligation to pay for the jewellery because, even though Jae Co has to pay a deposit, it can return unsold products after nine months in exchange for a refund.

In terms of control of the jewellery, it seems that Rodia Co retains control of the jewellery until sale to the final customer because as it can change the selling price of the jewellery and it retains legal title over it (and therefore could use it as security against a loan for example) until it is sold to the end customer.

The arrangement therefore appears to be a consignment arrangement and control of the jewellery remains with Rodia Co. As such, revenue for the sale of each item of jewellery should not be recognised by Rodia Co or by Jae Co until the item of jewellery has been sold to the end customer. Each item of jewellery should remain in the inventories balance of Rodia Co until it is sold to the end customer.

(c) **Right of return**

When the customer has a right to return products, the transaction price contains a variable element because the aggregate amount of revenue recognised by Kracker Co will vary. Kracker Co should therefore only recognise revenue to the extent that it is highly probable that a significant reversal in the amount of revenue recognised will not occur when the uncertainty is resolved, ie when the right of return period expires. Kracker Co reliably estimates that no more than 4% of goods of goods will be returned, so it is highly probable that goods sold for \$192,000 ($96 \times \$2,000$) will not reverse.

For the items expected to be returned, Kracker Co should not recognise any revenue, instead it should recognise a refund liability for \$8,000 ($\$200,000 - \$192,000$) as a current liability, and an asset representing the items expected to be returned for \$6,400 ($4\% \times 100 \times \$1,600$), shown as a right of return asset under current assets.

The journal entries required at the date of sale are:

| | | |
|---------------------------------------|-----------|-----------|
| Dr Trade receivable | \$200,000 | |
| Cr Revenue | | \$192,000 |
| Cr Refund liability | | \$8,000 |
| Dr Cost of sales (β) | \$153,600 | |
| Dr Right of return asset | \$6,400 | |
| Cr Inventory ($100 \times \$1,600$) | | \$160,000 |

The refund liability should be reassessed and updated at each reporting date. The right of return asset should be assessed for recoverability at each reporting date.

(d) **Non-refundable fee**

IFRS 15 requires an entity to assess whether a non-refundable up-front fee paid by a customer relates to the transfer of a promised good or service.

In this case, when a customer becomes a member, Kotta Co must set up a customer's account and issue them with a membership card. However, this appears to be an administrative task rather than a good or service transferred to the customer. IFRS 15 states that administrative tasks do not transfer a good or service to the customer and are not performance obligations.

Instead, the non-refundable fee is an advance payment for access to the community food store over the 12 month period. Kotta Co should recognise a contract liability on receipt of the fee, and then recognise the fee as revenue over the 12 month period, as the access to the food store is provided to the customer. As the customer can access the store at any time during the 12 month period, Kotta Co will need to determine the most appropriate way of allocating the revenue over the 12 month period. The most straightforward method may be a straight-line basis, if this is a suitable approximation for how customers use their access to the food store.

66 Seltec

Workbook references. Financial instruments are covered in Chapter 7, intangible assets in Chapter 3, and business combinations in Chapters 10 to 16.

Top tips. Part (a) of this question will likely have seemed daunting on first reading as it was 15 marks on a topic that a lot of students find difficult: financial instruments. However, as the directors of Seltec were unsure as to the nature of derivatives and hedge accounting techniques, this gives you a clue that there are marks available for presenting relevant knowledge of these topics: the definition of a derivative, the requirements for hedge accounting, the definitions and differences between a fair value hedge and a cash flow hedge and the definition of an embedded derivative. If you were unsure of these definitions, it is worth learning them as there will always be some marks available in an exam question for relevant knowledge, particularly when the topic is challenging.

In part (b), you need to think carefully about what constitutes a business combination. You should apply the guidance in IFRS 3, which is essentially an application of the substance over form principle.

Easy marks. These are available for the basic principles of intangible assets.

Marking scheme

| | | | Marks |
|-----|-----------------------|----------|-----------|
| (a) | Hedge accounting | 5 | 15 |
| | Futures | 5 | |
| | Embedded derivative | <u>5</u> | |
| (b) | Brands | 5 | 10 |
| | Business combinations | <u>5</u> | |
| | | | <u>25</u> |

(a) **Financial instruments**

Derivatives

IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments* define a **derivative** as a financial instrument or other contract that has all three of the following characteristics.

- (i) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying').
- (ii) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- (iii) It is settled at a future date.

A contract is **not considered to be a derivative where its purpose is to take physical delivery** in the normal course of business, unless the entity has a practice of settling the contracts on a net basis.

In the case of Seltec, while the company often takes physical delivery of the edible oil, it does so only to sell shortly afterwards, and usually settles on a net basis. Thus the **contracts will be considered to be derivative** contracts rather than contracts for purchase of inventory. Derivatives are accounted for at fair value through profit or loss, unless hedge accounting applies.

Hedge accounting

The rules on hedge accounting are set out in IFRS 9. Before a hedging relationship qualifies for hedge accounting, **all** of the following **conditions** must be met.

- (i) The hedging relationship consists **only of eligible hedging instruments and eligible hedged items**.
- (ii) There must be **formal documentation** (including identification of the hedged item, the hedging instrument, the nature of the risk that is to be hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk).
- (iii) The hedging relationship meets all of the following hedge effectiveness criteria
 - (1) There is an **economic relationship** between the hedged item and the hedging instrument, ie the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk;
 - (2) The **effect of credit risk does not dominate the value** changes that result from that economic relationship, ie the gain or loss from credit risk does not frustrate the effect of changes in the underlyings on the value of the hedging instrument or the hedged item, even if those changes were significant; and
 - (3) The **hedge ratio of the hedging relationship** (quantity of hedging instrument vs quantity of hedged item) is the same as that resulting from the quantity of the hedged item that the entity **actually hedges** and the quantity of the hedging instrument that the entity **actually uses** to hedge that quantity of hedged item.

There are two kinds of hedging that Seltec may consider: fair value hedging and cash flow hedging.

A **fair value hedge** is a hedge of the exposure to changes in the fair value of a recognised asset or liability, or an identified portion of such an asset or liability, that is attributable to a particular risk and could affect profit or loss. The **gain or loss** resulting from **re-measuring** the hedging instrument at fair value is **recognised in profit or loss**. The gain or loss on the hedged item attributable to the **hedged risk** should **adjust the carrying amount** of the hedged item and be **recognised in profit or loss**.