

A **cash flow hedge**: a hedge of the exposure to variability in cash flows that:

- (i) Is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction (such as an anticipated purchase or sale); and that
- (ii) Could affect profit or loss.

The portion of the gain or loss on the hedging instrument that is determined to be an **effective** hedge must be accounted for in a cash flow reserve and **recognised in other comprehensive income (items that may subsequently be reclassified to profit or loss)** and transferred to profit or loss when the hedged item is recognised in profit or loss. The **ineffective portion** of the gain or loss on the hedging instrument must be **recognised in profit or loss**.

The rules for cash flow hedges are particularly restrictive because it is difficult to isolate and measure the cash flows attributable to the specific risks for the non-financial items. Cash flow hedging results in higher volatility in earnings, so, provided the documentation and other requirements are met, **Seltec may prefer to use fair value hedging**. Seltec must take into account all changes in the price of edible oil of all types and geographical locations that it processes and sells and these must be compared with the changes in the value of the future. The hedge will be ineffective if the contracts have different prices. However, a hedge does not need to be fully effective, and hedge accounting may still be used provided the criteria above are met.

Embedded derivative

Certain contracts that are not themselves derivatives (and may not be financial instruments) include derivative contracts that are 'embedded' within them. These non-derivatives are called **host contracts**. IFRS 9 defines an embedded derivative as a derivative instrument that is combined with a non-derivative host contract to form a single hybrid instrument. Some of the cash flows of the instrument vary in a way that is similar to a stand-alone derivative.

Ordinary derivatives must be accounted for at fair value in the statement of financial position with changes recognised through profit or loss.

IFRS 9 treatment

Where the host contract is a financial asset within the scope of the IFRS 9, the classification and **measurement rules of the standard are applied to the entire hybrid contract**. However, in this case the contract is a financial liability, not a financial asset within the scope of IFRS 9. Accordingly, the following rules apply:

The embedded derivative must be **separated from its host contract** and accounted for as a derivative, provided the following conditions are met.

- (i) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract.
- (ii) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.
- (iii) The hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in the profit or loss (a derivative embedded in a financial asset or financial liability need not be separated out if the entity holds the combined instrument at fair value through profit or loss).

If the embedded derivative is separated from its host contract, the **host contract is accounted for under the applicable IFRS**. A contract denominated in a foreign currency contains an embedded derivative unless:

- (i) The foreign currency denominated in the contract is the currency of one of the parties to the contract.
- (ii) The foreign currency is that commonly used in the market in which such transactions take place.
- (iii) The foreign currency is that in which the related goods or services are denominated in routine commercial transactions.

In the case of Seltec, **none of the above three exceptions apply**. Seltec's trade in edible oil is generally in dollars, not pounds sterling, the pound is not the functional currency of either party, and it is not the currency normally used in transactions in the business environment in which Seltec operates. Finally, the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract, since changes in the price of oil and currency fluctuations have different risks.

In conclusion, IFRS 9 would treat Seltec's contracts as containing an embedded derivative. The currency derivative must be accounted for at fair value through profit or loss.

(b) **Intangible assets**

An entity should **assess** the useful life of an intangible asset, which may be **finite or indefinite**. An intangible asset has an indefinite useful life when there is **no foreseeable limit** to the period over which the asset is expected to generate net cash inflows for the entity.

Seltec wishes to treat both brands as having indefinite useful lives. However, this may not be appropriate, and there are certain factors that need to be considered:

- (i) Does the brand have long-term potential? The first brand has a proven track record, but the second, named after a famous film star, may last only as long as the film star's popularity, which will not be indefinite.
- (ii) Is Seltec committed to supporting the brand? In the case of the first, it is, but the second is a relatively new product, and it is not clear that Seltec is in for the long haul.

If, as is likely, the **useful life of the second brand is considered to be finite**, its cost less residual value should be amortised on a systematic basis over its useful life, using the straight-line method as an approximation if the pattern of benefits cannot be determined reliably.

The **first brand**, which is correctly said to have an **indefinite useful life**, should not be amortised. Its useful life should be reviewed at each reporting period to determine whether the assessment of the useful life as indefinite is still applicable. If not, the change, from indefinite to finite would be accounted for as a change in accounting estimate as per IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. It should also be tested for impairment annually in accordance with IAS 36 *Impairment of Assets*, and otherwise accounted for like the second brand.

Purchase of entities

IFRS 3 *Business Combinations* defines a business combination as 'a transaction or event in which an acquirer obtains control of one or more businesses. A business is 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 (such as dividends or interest) or generating other income from ordinary activities'. This is essentially an application of the substance over form principle.

IFRS 3 provides additional guidance as to whether an entity is a business. To qualify as a business, an entity must have at a minimum an **input** and a **substantive process** that together significantly contribute to the **ability to create an output**.

The two limited liability companies **do not have any substantive processes** at acquisition as they do not have any operational activity nor any employees (and so have no 'organised workforce' as specified in the application guidance to IFRS 3). **As such, they do not meet the IFRS 3 definition of a business** and the acquisition is not a business combination.

In substance, Seltec has purchased two assets (the two retail units) and the acquisition **should be treated as an asset acquisition**.

67 Della Co

Workbook references. Revenue recognition is covered in Chapter 3 and hedge accounting is covered in Chapter 7.

Top tips. Parts (a) and (b) related to revenue recognition covered in IFRS 15 *Revenue from Contracts with Customers*. In part (a) Della Co has entered into a repurchase agreement. The accounting treatment required by IFRS 15 depends on whether the repurchase price is higher or lower than the original purchase price - higher and it is a financing arrangement, lower and it is a lease. Even if you were not sure of the IFRS 15 specific guidance on repurchase agreements, you would have gained marks for discussing control of the asset and concluding that revenue should not be recognised immediately because control of the asset had not passed to the customer. You could also have noted that the contract seemed to be more like a financial liability - with Della Co repaying the original price plus interest, which would have gained some credit. In part (b), the agreement with Acra Co appears to be a consignment arrangement and so also accounted for under IFRS 15. Marks would be awarded for stating the relevant guidance in IFRS 15 for consignment arrangements, but if you were unaware of this guidance, you would have gained marks for discussing more generally which entity had control of product X at each point, and therefore when revenue could be recognised. In part (c), Della Co entered into a fair value hedging arrangement. The question specifically asked for a discussion of the hedge accounting requirements in IFRS 9, so there would be marks available for knowledge here. Even if you could not remember the hedge accounting criteria, notice that the hedging arrangement isn't entered into until 20X1, therefore there were marks available for discussing the standard IFRS 9 treatment of a financial asset at fair value through OCI at 31 December 20X0.

Marking scheme

	Marks
(a) Repurchase agreement	7
(b) Consignment arrangement	7
(c) Hedge accounting	<u>8</u>
	<u>25</u>

(a) Repurchase agreement

Della Co has entered into a repurchase agreement with Cromer Co because it has the right to cancel the sale and require return of the product at any point up to 31 January 20X1.

In accordance with IFRS 15 *Revenue from Contracts with Customers*, because Della Co has the right to repurchase the specialised product, Cromer Co does not obtain control of the product, even though it has physical possession of it, because it is limited in its ability to direct the use of the asset and to obtain substantially all of the remaining benefits from the asset. Therefore, Della Co cannot recognise any revenue on the date of the sale.

IFRS 15 specifies instead that:

- if the repurchase price is less than the original selling price, the transaction should be accounted for as a lease in accordance with IFRS 16 *Leases*
- if the repurchase price is the same or greater than the original selling price, the transaction should be accounted for as a financing arrangement.

The repurchase price for Della Co is \$500 higher than the original selling price, therefore it should be treated as a financing arrangement.

On the date of the sale, Della Co should not recognise any revenue and should not derecognise the specialised product, but should instead recognise a financial liability for \$242,000 for the amount received from Cromer Co. Della Co should also recognise an interest expense for \$500 over the two months to 31 January 20X1, which increases the liability.

On 31 January 20X1, if the contract is not cancelled, Della Co should derecognise the liability and recognise revenue of \$242,500.

(b) **Consignment arrangement**

This transaction appears to be a consignment arrangement. 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).

IFRS 15 defines control as the ability to direct the use of and to obtain substantially all the remaining benefits from the asset. From the information provided, product X appears to be controlled by Della Co until it is sold to the end customer because Della Co can dictate the selling price and legal title passes directly from Della Co to the end customer and does not transfer to Acra Co at any point.

Acra Co does not have an unconditional obligation to pay for the product, only amounts relating to items of product X that have been sold must be remitted to Della Co, and any remaining deposit at the end of the six-month period is refundable. Furthermore, Acra Co is required to return any unsold product at the end of the six-month trial period.

It therefore seems that this is a consignment arrangement. As such, any items of product X that are still held by Acra Co should be retained in the inventory balance of Della Co until they are sold to end customers. Della Co should only recognise revenue relating to product X on products which Acra Co has sold on to end customers.

Any remaining amount of the deposit paid by Acra Co is refundable on return of any unsold goods at the end of the trial period and should be recognised by Della Co as a current liability.

(c) **Hedge accounting**

At 31 December 20X0, the interest rate swap had not been arranged and therefore the fair value gain of \$500,000 on the investment in bonds should be accounted for through other comprehensive income. The finance income of \$120,000 ($\$2\text{m} \times 6\%$) should be recorded in profit or loss. The journal entries would be:

Debit Financial asset (bond)	\$500,000	
Debit Bank/cash	\$120,000	
Credit Finance income		\$120,000
Credit Other comprehensive income		\$500,000

On 1 January 20X1, Della Co entered into a hedging arrangement. In order to apply hedge accounting, IFRS 9 requires that 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** which includes identification of the hedged item and hedging instrument and the nature of the 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.

Assuming that all of this is in place and that the hedge effectiveness criteria are met, Della Co can apply the hedge accounting requirements of IFRS 9. As Della Co is hedging the risk that the fair value of the bond will change, it has entered into a fair value hedge.

The investment in bonds is the hedged item and the interest rate swap (a derivative) is the hedging instrument.

At 31 December 20X1, the interest rate swap should be recognised as a financial asset with a fair value of \$550,000 and a gain of \$550,000 should be recognised through profit or loss:

Debit Financial asset (swap)	\$550,000	
Credit Profit or loss		\$550,000

The fair value loss of \$600,000 (\$2.5m - \$1.9m) on the investment in bonds should then be recognised in profit or loss, rather than in other comprehensive income, to reflect the hedging relationship.

The interest income of \$120,000 on the bonds should be recognised as finance income through profit or loss.

The required journal entries are:

Debit Profit or loss	\$600,000	
Debit Bank/cash	\$120,000	
Credit Finance income		\$120,000
Credit Financial asset (bond)		\$600,000

ACCA

Strategic Business Reporting (International)

Mock Examination 1

Questions	
Time allowed	3 hours 15 minutes
This exam is divided into two sections	
Section A	BOTH questions are compulsory and MUST be attempted
Section B	BOTH questions are compulsory and MUST be attempted

DO NOT OPEN THIS EXAM UNTIL YOU ARE READY TO START
UNDER EXAMINATION CONDITIONS

Section A – BOTH questions are compulsory and MUST be attempted

1 Joey

Joey, a public limited company, operates in the media sector. Joey has two subsidiaries: Margy and Hulty.

The following exhibits provide information relevant to the question.

Exhibit 1 - Draft statements of financial position

The draft statements of financial position at 30 November 20X4 are as follows:

	Joey \$m	Margy \$m	Hulty \$m
Assets			
<i>Non-current assets</i>			
Property, plant and equipment	3,295	2,000	1,200
Investments in subsidiaries			
Margy	1,675		
Hulty	700		
	<u>5,670</u>	<u>2,000</u>	<u>1,200</u>
<i>Current assets</i>	985	861	150
Total assets	<u>6,655</u>	<u>2,861</u>	<u>1,350</u>
Equity and liabilities			
Share capital	850	1,020	600
Retained earnings	3,340	980	350
Other components of equity	250	80	40
Total equity	<u>4,440</u>	<u>2,080</u>	<u>990</u>
Total liabilities	<u>2,215</u>	<u>781</u>	<u>360</u>
Total equity and liabilities	<u>6,655</u>	<u>2,861</u>	<u>1,350</u>

Exhibit 2 - Acquisition of Margy

On 1 December 20X1, Joey acquired 30% of the ordinary shares of Margy for a cash consideration of \$600 million when the fair value of Margy's identifiable net assets was \$1,840 million. Joey has equity accounted for Margy up to 30 November 20X3. Joey's share of Margy's undistributed profit amounted to \$90 million and its share of a revaluation gain amounted to \$10 million for the period 1 December 20X1 to 30 November 20X3.

On 1 December 20X3, Joey acquired a further 40% of the ordinary shares of Margy for a cash consideration of \$975 million and gained control of the company. The cash consideration paid has been added to the equity accounted balance for Margy at 1 December 20X3 to give the carrying amount at 30 November 20X4.

At 1 December 20X3, the fair value of Margy's identifiable net assets was \$2,250 million. The excess of the fair value of the net assets over their carrying amount at that date is due to an increase in the value of non-depreciable land and a contingent liability. At 1 December 20X3, the fair value of the equity interest in Margy held by Joey before the business combination was \$705 million and the fair value of the non-controlling interest of 30% was assessed as \$620 million. The retained earnings and other components of equity of Margy at 1 December 20X3 were \$900 million and \$70 million respectively. It is group policy to measure the non-controlling interest at fair value. The goodwill that arises the acquisition of Margy has been tested for impairment and is not considered impaired.

Contingent liability

On 1 December 20X3, Joey included in the fair value of Margy's identifiable net assets, an unrecognised contingent liability with a fair value of \$6 million in respect of a warranty claim in progress against Margy, considered to have been measured reliably. In March 20X4, there was a revision of the estimate of the liability to \$5 million. The amount has met the criteria to be recognised as a provision in current liabilities in the financial statements of Margy and the revision of the estimate is deemed to be a measurement period adjustment.

Fair value of buildings

Buildings with a carrying amount of \$200 million had been included in the fair value of Margy's identifiable net assets at 1 December 20X3. The buildings have a remaining useful life of 20 years at 1 December 20X3 and are depreciated on the straight-line basis. However, Joey had commissioned an independent valuation of the buildings of Margy which was not complete at 1 December 20X3 and therefore not considered in the fair value of the identifiable net assets at the acquisition date. The valuations were received on 1 April 20X4 and resulted in a decrease of \$40 million in the fair value of property, plant and equipment at the date of acquisition. This decrease does not affect the fair value of the non-controlling interest at acquisition and has not been entered into the financial statements of Margy.

Exhibit 3 - Acquisition of Hulty

On 1 December 20X3, Joey acquired 80% of the equity interests of Hulty, a private entity, in exchange for cash of \$700 million, gaining control of Hulty from that date. Because the former owners of Hulty needed to dispose of the investment quickly, they did not have sufficient time to market the investment to many potential buyers. The fair value of the identifiable net assets was \$960 million. Joey determined that the fair value of the 20% non-controlling interest in Hulty at that date was \$250 million. Joey reviewed the procedures used to identify and measure the assets acquired and liabilities assumed and to measure the fair value of both the non-controlling interest and the consideration transferred. After that review, Hulty determined that the procedures and resulting measures were appropriate. The retained earnings and other components of equity of Hulty at 1 December 20X3 were \$300 million and \$40 million respectively. The excess in fair value is due to an unrecognised franchise right, which Joey had granted to Hulty on 1 December 20X2 for five years. At the time of the acquisition, the franchise right could be sold for its market price. It is group policy to measure the non-controlling interest at fair value.

Goodwill arising on the acquisition of Hulty has been tested for impairment and is not considered impaired.

Exhibit 4 - Property for sale

From 30 November 20X3, Joey carried a property in its statement of financial position at its revalued amount of \$14 million in accordance with IAS 16 *Property, Plant and Equipment*. Depreciation is charged at \$300,000 per year on the straight-line basis. In March 20X4, the management decided to sell the property and it was advertised for sale. On 31 March 20X4, the sale was considered to be highly probable and the criteria for IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* were met. At that date, the property's fair value was \$15.4 million and its value in use was \$15.8 million. Costs to sell the property were estimated at \$300,000. On 30 November 20X4, the property was sold for \$15.6 million. The transactions regarding the property are deemed to be material and no entries have been made in the financial statements regarding this property since 30 November 20X3 as the cash receipts from the sale were not received until December 20X4.

Exhibit 5 - Share options

The Joey Group has granted to the employees of Margy and Hulty, some of whom are considered key management personnel, options over its own shares as at 7 December 20X4. The options vest immediately. Joey is not proposing to make a charge to the subsidiaries for these options.

Joey does not know how to account for this transaction.

Exhibit 6 - Foreign currency loan

Joey took out a foreign currency loan of 5 million dinars at a fixed interest rate of 8% on 1 December 20X3. The interest is paid at the end of each year. The loan will be repaid after two years on 30 November 20X5. The interest rate is the current market rate for similar two-year fixed interest loans.

Joey is unsure how to account for the loan and related interest.

The average currency exchange rate for the year is not materially different from the actual rate.

Exchange rates:	\$1 = dinars
1 December 20X3	5.0
30 November 20X4	6.0
Average exchange rate for year ended 30 November 20X4	5.6

Required

- (a) (i) Explain, showing relevant calculations and with reference to IFRS 3 *Business Combinations*, how the goodwill balance in Joey's consolidated financial statements at 30 November 20X4 should be calculated. **(10 marks)**
- (ii) Explain how the transaction described in Exhibit 4 should be accounted for in Joey's consolidated financial statements at 30 November 20X4. **(6 marks)**
- (iii) Prepare, showing required calculations, an extract from Joey's consolidated statement of financial position showing the group retained earnings at 30 November 20X4. **(4 marks)**
- (b) Explain to Joey how the share options should be dealt with in the subsidiaries' financial statements and Joey's consolidated financial statements, and advise on any disclosures that may be required to ensure external stakeholders are aware of the transaction. **(5 marks)**
- (c) Explain to Joey how to account for the foreign currency loan and related interest in its individual financial statements for the year ended 30 November 20X4. **(5 marks)**
- (Total = 30 marks)**

2 Ramsbury

39 mins

The directors of Ramsbury, a public limited company which manufactures industrial cleaning products, are preparing the consolidated financial statements for the year ended 30 June 20X7. In your capacity as advisor to the company, you become aware of the issues described in the following exhibits.

Exhibit 1 - Loan to director

In the draft consolidated statement of financial position, the directors have included in cash and cash equivalents a loan provided to a director of \$1 million. The loan has no specific repayment date on it but is repayable on demand. The directors feel that there is no problem with this presentation as IFRS Standards allow companies to make accounting policy choices, and that showing the loan as a cash equivalent is their choice of accounting policy.

Exhibit 2 - Pension scheme amendment

On 1 July 20X6, there was an amendment to Ramsbury's defined benefit pension scheme whereby the promised pension entitlement was increased from 10% of final salary to 15%. A bonus is paid to the directors each year which is based upon the operating profit margin of Ramsbury. The directors of Ramsbury are unhappy that there is inconsistency on the presentation of gains and losses in relation to pension scheme within the consolidated financial statements. Additionally, they believe that as the pension scheme is not an integral part of the operating activities of Ramsbury, it is misleading to include the gains and losses in profit or loss. They therefore propose to change their accounting policy so that all gains and losses on the pension scheme are recognised in other comprehensive income. They believe that this will make the financial statements more consistent, more understandable and can be justified on the grounds of fair presentation. Ramsbury's pension scheme is currently in deficit.

Required

Discuss the ethical and accounting implications arising from the scenario, with reference to IFRS Standards. **(18 marks)**

Professional marks will be awarded in this question for the application of ethical principles. **(2 marks)**

(Total = 20 marks)

Section B – BOTH questions are compulsory and MUST be attempted

3 Klancet

Klancet is a public limited company operating in the pharmaceuticals sector. The company is seeking advice on several financial reporting issues.

The following exhibits provide information relevant to the question.

Exhibit 1 – Segment reporting

Klancet produces and sells its range of drugs through three separate divisions. In addition, it has two laboratories which carry out research and development activities.

In the first laboratory, the research and development activity is funded internally and centrally for each of the three divisions. It does not carry out research and development activities for other entities. Each of the three divisions is given a budget allocation which it uses to purchase research and development activities from the laboratory. The laboratory is directly accountable to the division heads for this expenditure.

The second laboratory performs contract investigation activities for other laboratories and pharmaceutical companies. This laboratory earns 75% of its revenues from external customers and these external revenues represent 18% of the organisation's total revenues.

The performance of the second laboratory's activities and of the three separate divisions is regularly reviewed by the chief operating decision maker (CODM). In addition to the heads of divisions, there is a head of the second laboratory. The head of the second laboratory is directly accountable to the CODM and they discuss the operating activities, allocation of resources and financial results of the laboratory.

The managing director does not think IFRS 8 provides information that is useful to investors. He feels it just adds more pages to financial statements that are already very lengthy. The finance director partially agrees with the managing director and believes that the IASB's practice statement on materiality confirms his opinion that not all the disclosure requirements in IFRS 8 are necessary.

Exhibit 2 – Drug development

Klancet is collaborating with Retto, a third party, to develop two existing drugs owned by Klancet.

Project 1

In the case of the first drug, Retto is simply developing the drug for Klancet without taking any risks during the development phase and will have no further involvement if regulatory approval is given. Regulatory approval has been refused for this drug in the past. Klancet will retain ownership of patent rights attached to the drug. Retto is not involved in the marketing and production of the drug. Klancet has agreed to make two non-refundable payments to Retto of \$4 million on the signing of the agreement and \$6 million on successful completion of the development.

Project 2

Klancet and Retto have entered into a second collaboration agreement in which Klancet will pay Retto for developing and manufacturing an existing drug. The existing drug already has regulatory approval. The new drug being developed by Retto for Klancet will not differ substantially from the existing drug. Klancet will have exclusive marketing rights to the drug if the regulatory authorities approve it. Historically, in this jurisdiction, new drugs receive approval if they do not differ substantially from an existing approved drug.

The contract terms require Klancet to pay an upfront payment on signing of the contract, a payment on securing final regulatory approval, and a unit payment of \$10 per unit, which equals the estimated cost plus a profit margin, once commercial production begins. The

cost-plus profit margin is consistent with Klancet's other recently negotiated supply arrangements for similar drugs.

Required

- (a) (i) Advise the managing director, with reference to IFRS 8 *Operating Segments*, whether the research and development laboratories should be reported as two separate operating segments. (6 marks)
- (ii) Discuss the managing director's view that IFRS 8 does not provide useful information to investors. (5 marks)
- (iii) Discuss whether the finance director is correct in his opinion about IFRS 8. You should briefly refer to Practice Statement 2 *Making Materiality Judgements* in your answer. (4 marks)

Professional marks will be awarded in Part (a) for clarity and quality of presentation.

(2 marks)

- (b) Prepare notes for a presentation to the managing director of Klancet as to how to account for the contracts with Retto in accordance with IFRS Standards. (8 marks)

(Total = 25 marks)

4 Jayach

Jayach is a public limited company with a reporting date of 30 November 20X2.

The following exhibits provide information relevant to the question.

Exhibit 1 - Fair values

Asset traded in different markets

Jayach carries an asset that is traded in different markets. The asset has to be valued at fair value under IFRS Standards. Jayach currently only buys and sells the asset in the Australasian market. The data relating to the asset are set out below.

Year to 30 November 20X2	Asian market	European market	Australasian market
Volume of market – units	4 million	2 million	1 million
Price	\$19	\$16	\$22
Costs of entering the market	\$2	\$2	\$3
Transaction costs	\$1	\$2	\$2

Decommissioning liability

Additionally, Jayach had acquired an entity on 30 November 20X2 and is required to fair value a decommissioning liability. The entity has to decommission a mine at the end of its useful life, which is in three years' time. Jayach has determined that it will use a valuation technique to measure the fair value of the liability. If Jayach were allowed to transfer the liability to another market participant, then the following data would be used.

Input	Amount
Labour and material cost	\$2 million
Overhead	30% of labour and material cost
Third party mark-up – industry average	20%
Annual inflation rate	5%
Risk adjustment – uncertainty relating to cash flows	6%
Risk-free rate of government bonds	4%
Entity's non-performance risk	2%

Exhibit 2 - Investment in iCoin

Jayach has recently employed a new managing director. The managing director has convinced the board that an investment in a new cryptocurrency, iCoin, would generate excellent capital gains. Consequently, Jayach purchased 50 units of iCoin for \$250,000 on 20 December 20X1. The finance director has expressed concern about how to report this investment in Jayach's 31 December 20X1 financial statements. Given the lack of an accounting standard for such investments, he sees no alternative but to include it as a cash equivalent. As the amount invested is less than the quantitative threshold Jayach has used to assess materiality, he is not planning to provide any further information about the investment in the financial statements.

Exhibit 3 - Email from shareholder

The directors of Jayach have received an email from its majority shareholder.

To: Directors of Jayach
From: A Shareholder
Re: Measurement

I have recently seen an article in the financial press discussing the 'mixed measurement approach' that is used by lots of companies. I hope this isn't the case at Jayach because 'mixed' seems to imply 'inconsistent'? Surely it would be better to measure everything in the same way? I would appreciate it if you could provide further information at the next annual general meeting on measurement bases, covering what approach is taken at Jayach and why, and the potential effect on investors trying to analyse the financial statements.

Required

- (a) Discuss, with relevant computations, how Jayach should measure the fair value of the asset traded in different markets and the decommissioning liability in accordance with IFRS 13 *Fair Value Measurement*. **(11 marks)**
- (b) (i) In the absence of a specific accounting standard on cryptocurrencies, discuss how Jayach should determine how to account for the investment in iCoin under IFRS Standards. **(4 marks)**
- (ii) Discuss the finance director's decision not to provide any further disclosures about the investment in the financial statements, making reference to IFRS Practice Statement 2 *Making Materiality Judgements*. **(4 marks)**
- (c) Prepare notes for the directors of Jayach which discuss the issues raised in the shareholder's email in Exhibit 3. You should refer to the *Conceptual Framework* where appropriate in your answer. **(6 marks)**

(Total = 25 marks)



Answers

DO NOT TURN THIS PAGE UNTIL YOU HAVE
COMPLETED THE MOCK EXAM



Section A

1 Joey

Workbook references. Basic groups and the principles of IFRS 3 are covered in Chapter 11. Step acquisitions are covered in Chapter 12. IFRS 5 is covered in Chapter 14. Share-based payment is covered in Chapter 10. IAS 21 is covered in Chapter 16.

Top tips. For step acquisitions, it is important to understand the transaction – here you have an associate becoming a subsidiary, so the goodwill calculation for Margy needs to include the fair value of the previously held investments. Remember to discuss the principles rather than just working through the calculations. The examiner has stated that a candidate will not be able to pass the SBR exam on numerical elements alone. The other goodwill calculation is very straightforward, the only unusual aspect being that it is a gain on a bargain purchase.

Don't skimp on parts (b) and (c) – there are five marks available.

Easy marks. There are some easy marks available in Part (a) for the standard parts of calculations of goodwill and retained earnings. The calculations in part (c) should also be relatively easy.

Marking scheme

			Marks
(a)	(i)	Goodwill	
		Calculation	4
		Discussion – 1 mark per point up to maximum	6
	(ii)	Asset held for sale	
		Calculation	3
		Discussion – 1 mark per point up to maximum	3
	(iii)	Retained earnings	4
			<u>4</u>
			20
(b)		Subjective assessment of discussion – 1 mark per point up to maximum	5
(c)		Calculation	3
		Discussion	2
			<u>2</u>
			10
			<u>30</u>

(a) (i) Goodwill

IFRS 3 *Business Combinations* requires goodwill to be recognised in a business combination. A business combination takes place when one entity, the acquirer, obtains control of another entity, the acquiree. IFRS 3 requires goodwill to be calculated and recorded at the acquisition date. Goodwill is the difference between the consideration transferred by the acquirer, the amount of any non-controlling interest and the fair value of the net assets of the acquiree at the acquisition date. When the business combination is achieved in stages, as is the case for Margy, the previously held interest in the now subsidiary must be remeasured to its fair value.

Applying these principles, the goodwill on the acquisition of Hulty and Margy should be calculated as follows:

	Hulty		Margy	
	\$m	\$m	\$m	\$m
Consideration transferred		700		975
Non-controlling interest (at fair value)		250		620
Fair value of previously held equity interest (Note (1))				705
Less fair value of net assets at acquisition				
Share capital	600		1,020	
Retained earnings	300		900	
Other components of equity	40		70	
Fair value adjustments:				
Land (Note (2) and W1)	–		266	
Contingent liability (Note (3))	–		(6)	
Franchise right (W1)	20		–	
		(960)		(2,250)
Gain on bargain purchase (Note (4))		(10)		50
Measurement period adjustments:				
Add decrease in FV of buildings (Note (5))				40
Contingent liability: \$6m – \$5m (Note (3))				(1)
Goodwill				89

Notes

- (1) Margy is a business combination achieved in stages, here moving from a 30% owned associate to a 70% owned subsidiary on 1 December 20X3. Substance over form dictates the accounting treatment as, in substance, an associate has been disposed of and a subsidiary has been purchased. From 1 December 20X3, Margy is accounted for as a subsidiary of Joey and goodwill on acquisition is calculated at this date. IFRS 3 requires that the previously held investment is remeasured to fair value and included in the goodwill calculation as shown above. Any gain or loss on remeasurement to fair value is reported in consolidated profit or loss.
- (2) IFRS 3 requires the net assets acquired to be measured at their fair value at the acquisition date. The increase in the fair value of Margy's net assets (that are not the result of specific factors covered in Notes (3) and (5) below) is attributed to non-depreciable land.
- (3) In accordance with IFRS 3, contingent liabilities should be recognised on acquisition of a subsidiary where they are a present obligation arising as the result of a past event and their fair value can be measured reliably (as is the case for the warranty claims) even if their settlement is not probable. Contingent liabilities after initial recognition must be measured at the higher of the amount that would be recognised under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognised under IFRS 3.
- (4) As the goodwill calculation for the acquisition of Hulty results in a negative value, this is a gain on a bargain purchase and should be recorded in profit or loss for the year attributable to the parent. Before doing so, Joey must review the goodwill calculation to ensure that it has correctly identified all of the assets acquired and all of the liabilities assumed, along with verifying that its measurement of the consideration transferred and the non-controlling interest is appropriate. Joey has completed this exercise and thus it is appropriate to record the negative goodwill and related profit.

- (5) As a result of the independent property valuation becoming available during the measurement period, the carrying amount of property, plant and equipment as at 30 November 20X4 is decreased by \$40 million less excess depreciation charged of \$2 million (\$40m/20 years), ie \$38 million. This will increase the carrying amount of goodwill by \$40 million as IFRS 3 allows the retrospective adjustment of a provisional figure used in the calculation of goodwill at the acquisition date where new information has become available about the circumstances that existed at the acquisition date. Depreciation expense for 20X4 is decreased by \$2 million.

Workings

1 Hulty: Fair value adjustments

	At acq'n 1 Dec 20X3	Movement (over 4 years)	At year end 30 Nov 20X4
	\$m	\$m	\$m
Franchise: $960 - (600 + 300 + 40)$	20	(5)	15

2 Margy: Fair value adjustments

	At acq'n 1 Dec 20X3	Movement (reduced dep'n)	At year end 30 Nov 20X4
	\$m	\$m	\$m
Land: $2,250 - (1,020 + 900 + 70) + 6^*$	266	—	266
Property, plant and equipment	(40)	2	(38)
*Contingent liability			

(ii) Asset held for sale

At 31 March 20X4, the criteria in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* have been met, and the property should be classified as held for sale. 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 any impairment in accordance with the applicable IFRS. Any impairment loss is generally recognised in profit or loss. The steps are as follows:

Step 1 Calculate carrying amount under applicable IFRS, here IAS 16 Property, Plant and Equipment:

At 31 March 20X4, the date of classification as held for sale, depreciation to date is calculated as $\$300,000 \times 4/12 = \$100,000$. The carrying amount of the property is therefore \$13.9 million (\$14.0 – \$0.1m). The journal entries are:

Debit	Profit or loss	\$0.1m	
Credit	Property, plant and equipment (PPE)		\$0.1m

The difference between the carrying amount and the fair value at 31 March 20X4 is material, so the property is revalued to its fair value of \$15.4 million under IAS 16's revaluation model:

Debit	PPE (\$15.4m – \$13.9m)	\$1.5m	
Credit	Other comprehensive income		\$1.5m

Step 2 Consider whether the property is impaired by comparing its carrying amount, the fair value of \$15.4 million, with its recoverable amount. The recoverable amount is the higher of value in use (given as \$15.8 million) and fair value less costs to sell (\$15.4m – \$3m = \$12.4m.) The property is not impaired because the recoverable amount (value in use) is higher than the carrying amount (fair value). No impairment loss is recognised.

Step 3 Classify as held for sale and cease depreciation under IFRS 5. Compare the carrying amount (\$15.4 million) with fair value less costs to sell (\$15.1 million). Measure at the lower of carrying amount and fair value less costs to sell, here \$15.1 million, giving an initial write-down of \$300,000.

Debit	Profit or loss	\$0.3m	
Credit	PPE		\$0.3m

Step 4 On 30 November 20X4, the property is sold for \$15.6 million, which, after deducting costs to sell of \$0.3 million gives a profit of \$0.2 million.

Debit	Receivables	\$15.3m	
Credit	PPE		\$15.1m
Credit	Profit or loss		\$0.2m

(iii) **Retained earnings**

JOEY GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 NOVEMBER 20X4
(EXTRACT)

	\$m
Retained earnings (W1)	3,451.7

Workings

1 *Group retained earnings*

	Joey \$m	Hulty \$m	Margy \$m
At year end	3,340.0	350	980
FV adjustment: dep'n reduction (part (a)(i) W2)			2
FV adjustment: franchise amortisation (part (a)(i) W1)		(5)	
Liability adjustment (6 – 1)* (part (a)(i))			5
Gain on bargain purchase (part (a)(i))	10.0		
Profit on derecognition of associate (W2)	5.0		
Asset held for sale: (0.2 – 0.1 – 0.3) (part (a)(ii))	(0.2)		
At acquisition		(300)	(900)
		<u>45</u>	<u>87</u>
Group share:			
Hulty: 80% × 45	36.0		
Margy: 70% × 87	60.9		
	<u>3,451.7</u>		

* The warranty claim provision of \$5 million in Margy's financial statements must be reversed on consolidation to avoid double counting. This is because the contingent liability for this warranty claim was recognised in the consolidated financial statements on acquisition of Margy.

2 *Profit on derecognition of 30% associate*

	\$m
Fair value of previously held equity interest at date control obtained (per question/(a) (i))	705
Carrying amount of associate: 600 cost + 90 (post-acq'n RE) + 10 (post acq'n OCE)	(700)
Profit	<u>5</u>

(b) **Share-based payment**

This arrangement will be governed by IFRS 2 *Share-based Payment*, which includes within its scope **transfers of equity instruments of an entity's parent in return for goods or services**. Clear guidance is given in the Standard as to **when to treat group share-based payment transactions as equity settled and when to treat them as cash settled**.

To determine the accounting treatment, the group entity receiving the goods and services must **consider its own rights and obligations as well as the awards granted**. The amount recognised by the group entity receiving the goods and services will not necessarily be consistent with the amount recognised in the consolidated financial statements.

Group share-based payment transactions **must be treated as equity settled** if either of the following apply:

- (i) The entity **grants rights to its own equity instruments**.
- (ii) The entity has **no obligation to settle** the share-based payment transactions.

Treatment in consolidated financial statements

Because the group receives all of the services in consideration for the group's equity instruments, the transaction is treated as **equity settled**. The fair value of the share-based payment at the grant date is **charged to profit or loss over the vesting period with a corresponding credit to equity**. In this case, the options vest immediately on the grant date, the employees not being required to complete a specified period of service and the services therefore being presumed to have been received. The fair value will be taken by reference to the market value of the shares because it is deemed not normally possible to measure directly the fair value of the employee services received.

Treatment in subsidiaries' financial statements

The subsidiaries do not have an obligation to settle the awards, so the grant is treated as an **equity settled** transaction. The fair value of the share-based payment at the grant date is **charged to profit or loss over the vesting period with a corresponding credit to equity**. The parent, Joey, is compensating the employees of the subsidiaries, Margy and Hulty, with no expense to the subsidiaries, and therefore the **credit in equity is treated as a capital contribution**. Because the shares vest immediately, the expense recognised in Margy and Hulty's statement of profit or loss will be the full cost of the fair value at grant date.

IAS 24 disclosures

Some of the employees are considered **key management personnel** and therefore IAS 24 *Related Party Disclosures* should be applied. IAS 24 requires disclosure of the related party relationship, the transaction and any outstanding balances at the year end date. Such disclosures are required in order to provide sufficient information to the users of the financial statements about the potential impact of related party transactions on an entity's profit or loss and financial position.

IAS 24 requires that an entity discloses key management personnel compensation in total and for several categories, of which share-based payments is one. IFRS Practice Statement 2 *Making Materiality Judgements* confirms that disclosures required in IFRSs need only be made if the information provided by the disclosure is **material**. Some related party transactions may be assessed as immaterial and therefore not disclosed. That said, the remuneration of key management personnel is of great interest to investors and it would be difficult to see how it could be considered immaterial.

(c) **Foreign currency loan**

On 1 December 20X3

On initial recognition (at 1 December 20X3), the loan is measured at the transaction price translated into the functional currency (the dollar), because the interest is at a market rate for a similar two-year loan. The loan is translated at the rate ruling on 1 December 20X3.

Debit	Cash $5\text{m} \div 5$	\$1m	
Credit	Financial liability (loan payable)		\$1m

Being recognition of loan

Year ended 30 November 20X4

Because there are no transaction costs, the effective interest rate is 8%. Interest on the loan is translated at the average rate because this is an approximation for the actual rate

Debit	Profit or loss (finance cost): $5\text{m} \times 8\% \div 5.6$	\$71,429	
Credit	Financial liability (loan payable)		\$71,429

Being recognition of finance costs for the year ended 30 November 20X4

On 30 November 20X4

The interest is paid and the following entry is made, using the rate on the date of payment of \$1 = 6 dinars

Debit	Financial liability (loan payable) $5\text{m} \times 8\% \div 6$	\$66,667	
Credit	Cash		\$66,667

Being recognition of interest payable for the year ended 30 November 20X4

In addition, as a monetary item, the loan balance at the year-end is translated at the spot rate at the year-end: $5\text{m dinars} \div 6 = \$833,333$. This gives rise to an exchange gain of $\text{£}1,000,000 - \$833,333 = \$166,667$.

The exchange gain on the interest paid of $\$71,429 - \$66,667 = \$4,762$ is added to the exchange gain on retranslation of the loan of $\$166,667$. This gives a total exchange gain of $\$4,762 + \$166,667 = \$171,429$.

2 Ramsbury

Workbook references. The *Conceptual Framework* is covered in Chapter 1 and ethics is covered in Chapter 2. Employee benefits are covered in Chapter 5.

Top tips. As with all questions, ensure that you apply your knowledge to the scenario provided and that your answer is in context. It is not enough to simply discuss the accounting requirements. You must draw out the ethical issues. Where relevant, you should identify any threats to the fundamental principles in ACCA's *Code of Ethics and Conduct*.

Marking scheme

	Marks
Accounting issues 1 mark per point to a maximum	9
Ethical issues 1 mark per point to a maximum	9
Professional marks	<u>2</u>
	<u>20</u>

Treatment of loan to director

The directors have included the loan made to the director as part of the cash and cash equivalents balance. It may be that the directors have misunderstood the definition of cash and cash equivalents, believing the loan to be a cash equivalent. IAS 7 *Statement of Cash Flows* defines cash equivalents as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. However, the loan is not in place to enable Ramsbury to manage its short-term cash

commitments, it has no fixed repayment date and the likelihood of the director defaulting is not known. The classification as a cash equivalent is therefore inappropriate.

It is likely that the loan should be treated as a financial asset under IFRS 9 *Financial Instruments*. Further information would be needed, for example, is the \$1 million the fair value? A case could even be made that, since the loan may never be repaid, it is in fact a part of the director's remuneration, and if so should be treated as an expense and disclosed accordingly. In addition, since the director is likely to fall into the category of key management personnel, related party disclosures under IAS 24 *Related Party Disclosures* are likely to be necessary.

The treatment of the loan as a cash equivalent is in **breach of the two fundamental qualitative characteristics** prescribed in the IASB's *Conceptual Framework for Financial Reporting*, namely:

- (i) **Relevance.** The information should be disclosed separately as it is relevant to users.
- (ii) **Faithful representation.** Information must be **complete, neutral** and **free from error**. Clearly this is not the case if a loan to a director is shown in cash.

The treatment is also in breach of the *Conceptual Framework*'s key **enhancing qualitative characteristics**:

- (i) **Understandability.** If the loan is shown in cash, it hides the true nature of the practices of the company, making the financial statements less understandable to users.
- (ii) **Verifiability.** Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. It means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation. The treatment does not meet this benchmark as it reflects the subjective bias of the directors.
- (iii) **Comparability.** For financial statements to be comparable year-on-year and with other companies, transactions must be correctly classified, which is not the case here. If the cash balance one year includes a loan to a director and the next year it does not, then you are not comparing like with like.

In some countries, loans to directors are **illegal**, with directors being personally liable. Even if this is not the case, there is a potential **conflict of interest** between that of the director and that of the company, which is why separate disclosure is required as a minimum. Directors are responsible for the financial statements required by statute, and thus it is their responsibility to put right any errors that mean that the financial statements do not comply with IFRS. There is generally a legal requirement to maintain proper accounting records, and recording a loan as cash conflicts with this requirement.

In obscuring the nature of the transaction, it is possible that the directors are **motivated by personal interest**, and are thus failing in their duty to act honestly and ethically. There is potentially a self-interest threat to the fundamental principles of the ACCA *Code of Ethics and Conduct*. If one transaction is misleading, it casts doubt on the credibility of the financial statements as a whole.

In conclusion, the treatment is problematic and **should be rectified**.

Ethical implications of change of accounting policy

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* only permits a change in accounting policy if the change is: (i) required by an IFRS or (ii) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. A retrospective adjustment is required unless the change arises from a new accounting policy with transitional arrangements to account for the change. It is possible to depart from the requirements of IFRS but only in the extremely rare circumstances where compliance would be so misleading that it would conflict with the overall objectives of the financial statements. Practically this override is rarely, if ever, invoked.

IAS 19 *Employee Benefits* requires all gains and losses on a defined benefit pension scheme to be recognised in profit or loss except for the remeasurement component relating to the assets and liabilities of the plan, which must be recognised in other comprehensive income. So, current service cost, past service cost and the net interest cost on the net defined benefit liability must all be recognised in profit or loss. There is no alternative treatment available to the directors, which, under IAS 8, a change in accounting policy might be applied to move Ramsbury to. The directors' proposals cannot be justified on the grounds of fair presentation. The directors have an ethical responsibility to prepare financial statements which are a true representation of the entity's performance and comply with all accounting standards.

There is a clear self-interest threat arising from the bonus scheme. The directors' change in policy appears to be motivated by an intention to overstate operating profit to maximise their bonus potential. The amendment to the pension scheme is a past service cost which must be expensed to profit or loss during the period the plan amendment has occurred, ie immediately. This would therefore be detrimental to the operating profits of Ramsbury and depress any potential bonus.

Additionally, it appears that the directors wish to manipulate other aspects of the pension scheme such as the current service cost and, since the scheme is in deficit, the net finance cost. The directors are deliberately manipulating the presentation of these items by recording them in equity rather than in profit or loss. The financial statements would not be compliant with IFRS, would not give a reliable picture of the true costs to the company of operating a pension scheme and this treatment would make the financial statements less comparable with other entities correctly applying IAS 19. Such treatment is against ACCA's *Code of Ethics and Conduct* fundamental principles of objectivity, integrity and professional behaviour. The directors should be reminded of their ethical responsibilities and must be dissuaded from implementing the proposed change in policy.

The directors should be encouraged to utilise other tools within the financial statements to explain the company's results such as drawing users attention towards the cash flow where the cash generated from operations measure will exclude the non-cash pension expense and if necessary alternative performance measures such as EBITDA could be disclosed where non-cash items may be consistently stripped out for comparison purposes.

Section B

3 Klancet

Workbook references. Segment reporting is covered in Chapter 18. Intangible assets are covered in Chapter 4. Financial instruments are covered in Chapter 8. IFRS Practice Statement 2 *Making Materiality Judgements* is covered in Chapter 20.

Top tips. In Part (a)(i), on segment reporting, the key was to argue that the second laboratory met the definition of an operating segment, while the first one did not. In Part (a)(ii) you should consider why segmental information is useful to investors – why would they want this information? What makes this information particularly useful to investors? Part (a)(iii) requires an awareness of current issues in financial reporting, in this case IFRS Practice Statement 2 *Making Materiality Judgements*. It is crucial that you read widely while studying SBR as questions on current issues will definitely feature in your exam.

In Part (b) the key issue was whether the costs could be capitalised as development expenditure, which was the case for the latter, but not the former.

Easy marks. These are available for discussing the principles and quantitative thresholds of IFRS 8 in Part (a).

Marking scheme

	Marks
(a) (i) Requirements of IFRS 8 – 1 mark per point up to maximum	6
(ii) Usefulness of IFRS 8 – 1 mark per point up to maximum	5
(iii) Materiality – 1 mark per point up to maximum	4
(b) Notes for presentation – 1 mark per point up to maximum	8
Professional marks (Part (a))	<u>2</u>
	<u>25</u>

(a) (i) Segment reporting

IFRS 8 *Operating Segments* states that an operating segment is a component of an entity which engages in business activities from which it may earn revenues and incur costs. In addition, discrete financial information should be available for the segment and these results should be regularly reviewed by the entity's chief operating decision maker (CODM) when making decisions about resource allocation to the segment and assessing its performance.

Other factors should be taken into account, including the nature of the business activities of each component, the existence of managers responsible for them, and information presented to the board of directors.

According to IFRS 8, an operating segment is one which meets any of the following quantitative thresholds:

- (i) Its reported revenue is 10% or more of the combined revenue of all operating segments.
- (ii) The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of (1) the combined reported profit of all operating segments which did not report a loss and (2) the combined reported loss of all operating segments which reported a loss.
- (iii) Its assets are 10% or more of the combined assets of all operating segments.

As a result of the application of the above criteria, the first laboratory will not be reported as a separate operating segment. The divisions have heads directly accountable to, and maintaining regular contact with, the CODM to discuss all aspects of their division's performance. The divisions seem to be consistent with the core principle of IFRS 8 and should be reported as separate segments. The laboratory does not have a separate segment manager and the existence of a segment manager is normally an important factor in determining operating segments. Instead, the laboratory is responsible to the divisions themselves, which would seem to indicate that it is simply supporting the existing divisions and not a separate segment. Additionally, there does not seem to be any discrete performance information for the segment, which is reviewed by the CODM.

The second laboratory should be reported as a separate segment. It meets the quantitative threshold for percentage of total revenues and it meets other criteria for an operating segment. It engages in activities which earn revenues and incurs costs, its operating results are reviewed by the CODM and discrete information is available for the laboratory's activities. Finally, it has a separate segment manager.

- (ii) Contrary to the managing director's views, IFRS 8 provides information that makes the financial statements more relevant and more useful to investors. IFRS financial statements are highly aggregated and may prevent investors from understanding the many different business areas and activities that an entity is engaged in. IFRS 8 requires information to be disclosed that is not readily available elsewhere in the financial statements, therefore it provides additional information which aids an investor's understanding of how the business operates and is managed.

IFRS 8 uses a 'management approach' to report information on an entity's segments and results from the point of view of the decision makers of the entity. This allows investors to examine an entity 'through the eyes of management' – to see the business in the way in which the managers who run the business on their behalf see it. This provides investors with more discrete information on the business segments allowing them to better assess the return being earned from those business segments, the risks that are associated with those segments and how those risks are managed. The more detailed information provides investors with more insight into an entity's longer term performance.

The requirement to disclose information that is actually used by internal decision makers is an important feature of IFRS 8, but is also one of its main criticisms. The fact that the reporting does not need to be based on IFRS makes it difficult to make comparisons with information that was reported in prior periods and with other companies in the sector. The flexibility in reporting can make it easier to manipulate what is reported. IFRS 8 disclosures are often most useful if used in conjunction with narrative disclosures prepared by the directors of the company, such as the Strategic Review in the UK.

- (iii) The finance director's opinion that 'not all the disclosure in IFRS 8 is necessary' could be interpreted to mean that he believes he can pick and choose which disclosure requirements he feels are necessary and which he believes are not.

This is not correct. IAS 1 Presentation of Financial Statements requires all standards to be applied if fair presentation is to be achieved. Directors cannot choose which parts of standards they do or do not apply.

However, as confirmed by Practice Statement 2, if the information provided by a disclosure is immaterial and it therefore cannot reasonably be expected to influence the decisions of primary users of the financial statements, then that disclosure does not need to be made.

If the finance director is suggesting that the information provided about Klancet by some of the disclosures required by IFRS 8 are not material, then assuming that the information is indeed immaterial, he would be correct in stating that those disclosures are not necessary.

The directors should apply the principles given in Practice Statement 2 to review how they have made materiality judgements in their financial reporting. It may be that their current financial report is very lengthy because they include information that is not material.

Tutorial note. Consideration of the ethical issues was not part of the question requirement, however, it is clear both directors appear reluctant to give the disclosures required by IFRS 8 which raises concern. If the finance director is not aware that he cannot pick and choose requirements from IFRS Standards, then his professional competence may be called into question. If he is aware of this, and an assessment of whether the disclosures are material has not been done, or has been done inappropriately, then it may be that the directors are trying to hide an issue which should be considered in more detail.

(b) **Development of drugs**

Notes for presentation to the managing director

1 Criteria for recognising as an asset

IAS 38 *Intangible Assets* requires an entity to recognise an intangible asset, whether purchased or self-created (at cost) if, and only if, it is **probable** that the future economic benefits which are attributable to the asset will flow to the entity and the cost of the asset can be **measured reliably**.

2 Internally generated intangible assets

The recognition requirements of IAS 38 apply whether an intangible asset is acquired externally or generated internally. IAS 38 includes additional recognition criteria for internally generated intangible assets.

Development costs are capitalised only after technical and commercial feasibility of the asset for sale or use have been established. This means that the entity must intend and be able to complete the intangible asset and either use it or sell it and be able to demonstrate how the asset will generate future economic benefits, in keeping with the recognition criteria.

If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure for that project as if it were incurred in the research phase only.

The price which an entity pays to acquire an intangible asset reflects its expectations about the probability that the expected future economic benefits in the asset will flow to the entity.

3 Project 1

Klancet owns the potential new drug, and Retto is carrying out the development of the drug on its behalf. The risks and rewards of ownership remain with Klancet.

By paying the initial fee and the subsequent payment to Retto, Klancet does not acquire a separate intangible asset. The payments represent research and development by a third party, which need to be expensed over the development period provided that the recognition criteria for internally generated intangible assets are not met.

Development costs are capitalised only after technical and commercial feasibility of the asset for sale or use have been established. This means that the entity must intend and be able to complete the intangible asset and either use it or sell it and be able to demonstrate how the asset will generate future economic benefits. At present, this criterion does not appear to have been met as regulatory authority for the use of the drug has not been given and, in fact, approval has been refused in the past.

4 Project 2

In the case of the second project, the drug has already been discovered and therefore the costs are for the development and manufacture of the drug and its slight modification. There is no indication that the agreed prices for the various elements are not at fair value. In particular, the terms for product supply at cost plus profit are consistent with Klancet's other supply arrangements.

Therefore, Klancet should capitalise the upfront purchase of the drug and subsequent payments as incurred, and consider impairment at each financial reporting date. Regulatory approval has already been attained for the existing drug and therefore there is no reason to expect that this will not be given for the new drug. Amortisation should begin once regulatory approval has been obtained. Costs for the products have to be accounted for as inventory using IAS 2 *Inventories* and then expensed as costs of goods sold as incurred.

4 Jayach

Workbook references. Fair value measurement under IFRS 13 is covered in Chapter 4. The *Conceptual Framework* is covered in Chapter 1, IAS 8 in Chapter 2 and Practice Statement 2 in Chapter 20.

Top tips. Fair value measurement affects many aspects of financial reporting. Part (a) requires application of IFRS 13 to the valuation of assets and liabilities. Ensure that you provide explanations to support your workings. Part (b) looks at an investment in cryptocurrency for which there is no specific accounting standard. Don't panic if you see such a question in your exam. Sensible points which apply the principles of IAS 8 and the *Conceptual Framework* will gain marks. Part (c) considers the topic of measurement from a wider perspective. Make sure you relate your answer to the email given in the question. Remember that the examiner has recommended that you read widely, including technical articles and real financial reports, to support your learning.

Easy marks. Credit will be given for textbook knowledge in Part (a).

Marking scheme

		Marks
(a)	1 mark per point up to maximum of	6
	Calculations	<u>5</u>
		11
(b)	(i) 1 mark per point up to maximum of	4
	(ii) 1 mark per point up to maximum of	<u>4</u>
		8
(c)	1 mark per point up to maximum of	<u>6</u>
		<u>25</u>

(a) Fair value of asset

YEAR TO 30 NOVEMBER 20X2

	Asian market	European market	Australasian market
Volume of market – units	<u>4m</u>	<u>2m</u>	<u>1m</u>
Price	\$ 19	\$ 16	\$ 22
Costs of entering the market	<u>(2)</u>	<u>(2)</u>	<u>–</u>
Potential fair value	17	14	22
Transaction costs	<u>(1)</u>	<u>(2)</u>	<u>(2)</u>
Net profit	<u>16</u>	<u>12</u>	<u>20</u>

Notes

- 1 Because Jayach currently buys and sells the asset in the Australasian market, the **costs of entering that market** are not incurred and therefore **not relevant**.
- 2 Fair value is **not adjusted for transaction costs**. Under IFRS 13, these are not a feature of the asset or liability, but may be taken into account when determining the most advantageous market.
- 3 The **Asian market is the principal market** for the asset because it is the market with the greatest volume and level of activity for the asset. If information about the Asian market is available and Jayach can access the market, then Jayach should base its fair value on this market. Based on the Asian market, the **fair value of the asset would be \$17**, measured as the price that would be received in that market (\$19) less costs of entering the market (\$2) and ignoring transaction costs.
- 4 If **information** about the Asian market is **not available**, or if Jayach **cannot access the market**, Jayach must measure the fair value of the asset using the price in the **most advantageous market**. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account both transaction costs and usually also costs of entry, which is the net amount that would be received in the respective markets. The most advantageous market here is therefore the **Australasian market**. As explained above, costs of entry are not relevant here, and so, based on this market, the **fair value would be \$22**.

It is assumed that market participants are independent of each other and knowledgeable, and able and willing to enter into transactions.

Fair value of decommissioning liability

Because this is a business combination, Jayach must measure the liability at fair value in accordance with IFRS 13, rather than using the best estimate measurement required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In most cases there will be no observable market to provide pricing information. If this is the case here, Jayach will use **the expected present value technique** to measure the fair value of the decommissioning liability. If Jayach were contractually committed to transfer its decommissioning liability to a market participant, it would conclude that a market participant would use the inputs as follows, arriving at a **fair value of \$3,215,000**.

Input	Amount \$'000
Labour and material cost	2,000
Overhead: 30% × 2,000	600
Third party mark-up – industry average: 2,600 × 20%	520
	<u>3,120</u>
Inflation adjusted total (5% compounded over three years): 3,120 × 1.05 ³	3,612
Risk adjustment – uncertainty relating to cash flows: 3,612 × 6%	217
	<u>3,829</u>
Discount at risk-free rate plus entity's non-performance risk (4% + 2% = 6%): 3,829/1.06 ³	<u>3,215</u>

- (b) (i) It isn't appropriate for Jayach to classify the investment as a cash equivalent purely because it is unsure of how else to account for it. In the absence of an IFRS covering investments in cryptocurrencies, the directors of Jayach should use judgement to develop an appropriate accounting policy.

In developing the policy, IAS 8 *Accounting Policies, Accounting Estimates and Errors* requires that the directors consider:

- (1) IFRSs dealing with similar issues. For example, the specific facts and circumstances could lead Jayach to conclude that the investment is an intangible asset accounted for under IAS 38 *Intangible Assets*.

- (2) The *Conceptual Framework*. The investment appears to meet the definition of an asset: a present economic resource controlled by the entity as a result of past events. Consideration should be given to the recognition criteria and to other issues such as the measurement basis to apply and how measurement uncertainty may affect that choice given the volatility of cryptocurrencies.
- (3) The most recent pronouncements of other national GAAPs based on a similar conceptual framework and accepted industry practice. This is sparse. The Australian Accounting Standards Board have concluded that standard setting activity on cryptocurrencies should be undertaken by the IASB.

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

- (ii) The finance director's decision to not provide any further disclosure about the investment in iCoin is questionable.

The objective of Jayach's financial report is to provide financial information which is useful to its primary users in making decisions about providing resources to Jayach. Practice Statement 2 re-affirms the principle in IFRS that information that is not material does not need to be disclosed in the financial statements. However, whether this information is material should be properly assessed.

Practice Statement 2 recommends that assessment of materiality should be performed with reference to both quantitative factors and qualitative factors. So far, the finance director has only considered quantitative factors, but qualitative factors should be considered. For example, the fact that this investment not the usual type of investment made by Jayach is a qualitative factor. The presence of a qualitative factor lowers the quantitative threshold below what would otherwise be used – so in this case, the investment could be material.

Furthermore, the investment is risky because cryptocurrencies are highly volatile. If it is Jayach's plan to invest in more cryptocurrencies in the future, or even to accept cryptocurrencies as payment, then this investors are likely to consider this important. Depending on their risk appetite, investors may consider the investment too risky and therefore inappropriate, and may be concerned about the potential future impact should Jayach decide to invest more in such currencies.

Part of the decision-making that primary users make on the basis of financial statements involves assessing management's stewardship of Jayach's resources. Some investors may consider this not to be good stewardship, given the risk involved.

- (c) A 'mixed measurement' approach means that a company selects a different measurement basis (eg historical cost or current value) for its various assets and liabilities, rather than using a single measurement basis for all items. The measurement basis selected should reflect the type of entity and sector in which it operates and the business model that the entity adopts.

Some investors have criticised the mixed measurement approach because they think that if different measurement bases are used for assets and liabilities, the resulting totals can have little meaning or lack relevance.

However, a single measurement basis may not provide the most relevant information to users. A particular measurement basis may be easier to understand, more verifiable and less costly to implement. Therefore, a mixed measurement approach is not 'inconsistent' but can actually provide more relevant information for stakeholders.

The *Conceptual Framework* confirms that the IASB uses a mixed measurement approach in developing standards. The measurement methods included in standards are those which the IASB believes provide the most relevant information and which most faithfully represent the underlying transaction or event. It seems that most investors feel that this approach is consistent with how they analyse financial statements. The problems of mixed measurement appear to be outweighed by the greater relevance achieved.

Jayach prepares its financial statements under IFRSs, and therefore applies the measurement bases permitted in IFRSs. IFRSs adopt a mixed measurement basis, which includes current value (fair value, value in use, fulfilment value and current cost) and historical cost.

When an IFRS allows a choice of measurement basis, the directors of Jayach must exercise judgement as to which basis will provide the most useful information for its primary users. Furthermore, when selecting a measurement basis, the directors should consider measurement uncertainty. The *Conceptual Framework* states that for some estimates, a high level of measurement uncertainty may outweigh other factors to such an extent that the resulting information may have little use.

ACCA

Strategic Business Reporting (International)

Mock Examination 2

Questions	
Time allowed	3 hours 15 minutes
This exam is divided into two sections	
Section A	BOTH questions are compulsory and MUST be attempted
Section B	BOTH questions are compulsory and MUST be attempted

DO NOT OPEN THIS EXAM UNTIL YOU ARE READY TO START
UNDER EXAMINATION CONDITIONS

Section A – BOTH questions are compulsory and MUST be attempted

1 Kutchen Co

Kutchen Co is a listed company which acquired two subsidiaries, House Co and Mach Co, during the year ended 31 December 20X6. Niche Co is a third subsidiary that was both acquired and disposed of during the same period. Kutchen Co has also restructured one of its business segments during the year ended 31 December 20X6.

The following exhibits provide information that is relevant to the question.

Exhibit 1 - Acquisition of House (70%)

On 1 June 20X6, Kutchen Co acquired 70% of the equity interests of House Co. The purchase consideration comprised 20 million shares of \$1 of Kutchen Co at the acquisition date and a further 5 million shares on 31 December 20X7 if House Co's net profit after taxation was at least \$4 million.

The market price of Kutchen Co's shares on 1 June 20X6 was \$2 per share and that of House Co's shares was \$4.20 per share. It is felt that there is a 20% chance of the profit target being met.

In accounting for the acquisition of House Co, the finance director did not take into account the non-controlling interest (NCI) in the goodwill calculation. He determined that a gain on a bargain purchase of \$8 million arose on the acquisition of House Co, being the purchase consideration of \$40 million less the fair value of the identifiable net assets of House Co acquired on 1 June 20X6 of \$48 million. This valuation was included in the group financial statements in Exhibit 6.

After the directors Kutchen Co discovered the error, they decided to measure the NCI at fair value at the date of acquisition. The fair value of the NCI in House Co was to be based upon quoted market prices at acquisition. House Co had issued share capital of \$1 each, totaling \$13 million at 1 June 20X6 and there has been no change in this amount since acquisition.

Exhibit 2 - Mach Co initial acquisition (80%)

On 1 January 20X6, Kutchen Co acquired 80% of the equity interests of Mach Co, a privately owned entity, for a consideration of \$57 million. The consideration comprised cash of \$52 million and the transfer of non-depreciable land with a fair value of \$5 million. The carrying amount of the land at the acquisition date was \$3 million and the land has only recently been transferred to the seller of the shares in Mach Co and is still carried at \$3 million in the group financial statements at 31 December 20X6.

At the date of acquisition, the identifiable net assets of Mach Co had a fair value of \$55 million. Mach Co had made a profit for the year attributable to ordinary shareholders of \$3.6 million for the year to 31 December 20X5.

The directors of Kutchen Co wish to measure the non-controlling interest at fair value at the date of acquisition but had again omitted NCI from the goodwill calculation. The NCI is to be measured at fair value using a public entity market multiple method. The directors of Kutchen Co have identified two companies which are comparable to Mach Co and which are trading at an average price to earnings ratio (P/E ratio) of 21. The directors have adjusted the P/E ratio to 19 for differences between the entities and Mach Co, for the purpose of fair valuing the NCI. The finance director has determined that a bargain purchase of \$3 million arose on the acquisition of Mach Co being the cash consideration of \$52 million less the fair value of the net assets of Mach Co of \$55 million. This gain on the bargain purchase had been included in the group financial statements in Exhibit 6.

Exhibit 3 - Acquisition and disposal of Niche Co (80%)

Kutchen Co had purchased an 80% interest in Niche Co for \$40 million on 1 January 20X6 when the fair value of the identifiable net assets was \$44 million. The partial goodwill method had been used to calculate goodwill and an impairment of \$2 million had arisen in the year ended 31 December 20X6. The holding in Niche Co was sold for \$50 million on 31 December 20X6. The carrying amount of Niche Co's identifiable net assets other than goodwill was \$60 million at the date of sale. Kutchen Co had carried the investment in Niche at cost. The finance director calculated that a gain arose of \$2 million on the sale of Niche Co in the group financial statements being the sale proceeds of \$50 million less \$48 million being their share of the identifiable net assets at the date of sale (80% of \$60 million). This was credited to retained earnings.

Exhibit 4 - Business segment restructure

Kutchen Co has decided to restructure one of its business segments. The plan was agreed by the board of directors on 1 October 20X6 and affects employees in two locations. In the first location, half of the factory units were closed on 1 December 20X6 and the affected employees' pension benefits have been frozen. Any new employees will not be eligible to join the defined benefit plan. After the restructuring, the present value of the defined benefit obligation in this location is \$8 million. The following table relates to location 1.

<i>Value before restructuring</i>	<i>Location 1</i>
	\$m
Present value of defined benefit obligation	(10)
Fair value of plan assets	7
Net pension liability	(3)

In the second location, all activities have been discontinued. It has been agreed that employees will receive a payment of \$4 million in exchange for the pension liability of \$2.4 million in the unfunded pension scheme.

Kutchen Co estimates that the costs of the above restructuring excluding pension costs will be \$6 million. Kutchen Co has not accounted for the effects of the restructuring in its financial statements because it is planning a rights issue and does not wish to depress the share price. Therefore, there has been no formal announcement of the restructuring.

Exhibit 5 - Mach Co subsequent acquisition of 20%

When Kutchen Co acquired the majority shareholding in Mach Co, there was an option on the remaining non-controlling interest (NCI), which could be exercised at any time up to 31 March 20X7. On 31 January 20X7, Kutchen Co acquired the remaining NCI in Mach Co. The payment for the NCI was structured so that it contained a fixed initial payment and a series of contingent amounts payable over the following two years.

The contingent payments were to be based on the future profits of Mach Co up to a maximum amount. Kutchen Co felt that the fixed initial payment was an equity transaction. Additionally, Kutchen Co was unsure as to whether the contingent payments were either equity, financial liabilities or contingent liabilities.

After a board discussion which contained disagreement as to the accounting treatment, Kutchen Co is preparing to disclose the contingent payments in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets. The disclosure will include the estimated timing of the payments and the directors' estimate of the amounts to be settled.

Exhibit 6 - Group statement of financial position

Group statement of financial position as at 31 December 20X6

Assets	\$
Non-current assets	
Property, plant and equipment	365
Goodwill	-
Intangible assets	<u>23</u>
	388
Current assets	<u>133</u>
Total assets	<u>521</u>
Equity and liabilities	
Share capital of \$1 each	63
Retained earnings	56
Other components of entity	26
Non-controlling interest	<u>3</u>
	148
Non-current liabilities	101
Current liabilities	
Trade payables	<u>272</u>
	373
Total liabilities	<u>521</u>

Required

- (a) Explain to the directors of Kutchen Co, with suitable workings, how goodwill should have been calculated on the acquisition of House Co and the initial acquisition of Mach Co showing the adjustments which need to be made to the consolidated financial statements to correct any errors by the finance director. **(10 marks)**
- (b) Explain, with suitable calculations, how the gain or loss on the sale of Niche Co should have been recorded in the group financial statements. **(5 marks)**
- (c) Discuss, with suitable workings, how the pension scheme should be dealt with after the restructuring by Kutchen Co of its business segment and whether a provision for restructuring should have been made in the financial statements for the year ended 31 December 20X6. **(7 marks)**
- (d) Advise Kutchen Co on the difference between equity and liabilities, and on the proposed accounting treatment of the contingent payments on the subsequent acquisition of 20% of Mach Co. **(8 marks)**
- (Total = 30 marks)**

The accountant of Abby Co is concerned about the disclosure of trading that has occurred between Abby Co and a company that a director of Abby Co is associated with. This director is also attempting to influence how the accountant should account for two issues associated with the consolidated financial statements. The following exhibits provide information relevant to Abby Co.

Exhibit 1 - Related party transactions

The accountant has discovered that the finance director of Abby Co has purchased goods from a company, Arwright Co, which one of the director's jointly owns with his wife and the accountant believes that this purchase should be disclosed. However, the director refuses to disclose the transaction as in his opinion it is an 'arm's length' transaction. He feels that if the transaction is disclosed, it will be harmful to business and feels that the information asymmetry caused by such non-disclosure is irrelevant as most entities undertake related party transactions without disclosing them. Similarly, the director felt that competitive harm would occur if disclosure of operating segment profit or loss was made. As a result, the entity only disclosed a measure of total assets and total liabilities for each reportable segment.

When preparing the financial statements for the recent year end, the accountant noticed that Arwright Co has not paid an invoice for several million dollars and it is significantly overdue for payment. It appears that the entity has liquidity problems and it is unlikely that Arwright Co will pay. The accountant believes that a loss allowance for trade receivables is required. The finance director has refused to make such an allowance and has told the accountant that the issue must not be discussed with anyone within the trade because of possible repercussions for the credit worthiness of Arwright Co.

Exhibit 2 - Subsidiary fair value adjustments

Additionally, when completing the consolidated financial statements, the director has suggested that there should be no positive fair value adjustments for a recently acquired subsidiary and has stated that the accountant's current position is dependent upon following these instructions. The fair value of the subsidiary is \$50 million above the carrying amount in the financial records. The reason given for not fair valuing the subsidiary's net assets is that goodwill is an arbitrary calculation which is meaningless in the context of the performance evaluation of an entity.

Exhibit 3 - Goodwill impairment calculation

Finally, when preparing the annual impairment tests of goodwill arising on other subsidiaries, the director has suggested that the accountant is flexible in the assumptions used in calculating future expected cash flows, so that no impairment of goodwill arises. He has specifically suggested that the accountant should use a discount rate which reflects risks for which future cash flows have been adjusted. He has indicated that he will support a salary increase for the accountant if he follows his suggestions.

Required

Discuss the ethical and accounting implications of the director's suggestions from the perspective of the reporting accountant. (18 marks)

Professional marks will be awarded in question 2 for the application of ethical principles.

(2 marks)

(Total = 20 marks)

Section B – BOTH questions are compulsory and MUST be attempted

3 Africant Co

49 mins

Africant Co owns several farms and also owns a division which sells agricultural vehicles. It is considering selling this agricultural retail division and wishes to measure the fair value of the inventory of vehicles for the purpose of the sale. The directors are also considering several options to value some farmland that the company owns. Finally, the directors are preparing for a forthcoming meeting with shareholders and thinking about questions they might be asked regarding a mixed measurement approach for assets and liabilities.

The following exhibits provide information relevant to the question.

Exhibit 1 - Vehicles

Three markets currently exist for the vehicles. Africant Co has transacted regularly in all three markets.

At 31 December 20X5, Africant Co wishes to find the fair value of 150 new vehicles, which are identical. The current volume and prices in the three markets are as follows:

Market	Sales price per vehicle \$	Historical volume – vehicles sold by Africant Co	Total volume of vehicles sold in the market	Transaction costs per vehicle \$	Transport cost to market per vehicle \$
Europe	40,000	6,000	150,000	500	400
Asia	38,000	2,500	750,000	400	700
Africa	34,000	1,500	100,000	300	600

Africant Co wishes to value the vehicles at \$39,100 per vehicle as these are the highest net proceeds per vehicle, and Europe is the largest market for Africant Co's product.

The directors of Africant Co are unclear about the principles behind the valuation of the new vehicles and also whether their valuation would be acceptable under IFRS 13 *Fair Value Measurement*.

Exhibit 2 - Land

Africant Co uses the revaluation model for its non-current assets. Africant Co has several plots of farmland which are unproductive. The company directors of Africant Co believe that the land would have more value if it were used for residential purposes. There are several potential purchasers for the land but planning permission has not yet been granted for use of the land for residential purposes. However, preliminary enquiries with the regulatory authorities seem to indicate that planning permission may be granted. Additionally, the government has recently indicated that more agricultural land should be used for residential purposes.

Africant Co has also been approached to sell the land for commercial development at a higher price than that for residential purposes and understands that fair value measurement of a non-financial asset takes into account a market perspective. The directors of Africant Co are unclear about what is meant by a 'market perspective' and how to measure the fair value of the land in its financial statements.

Exhibit 3 - Mixed measurement approach

Africant Co is about to hold its annual general meeting with shareholders and the directors wish to prepare for any potential questions which may be raised at the meeting. There have been discussions in the media over the fact that the most relevant measurement method should be selected for each category of assets and liabilities. This 'mixed measurement approach' is used by many entities when preparing financial statements. There have also been comments in the media about the impact that measurement uncertainty and price volatility can have on the quality of financial information.

Required

- (a) Advise Africant Co on the appropriate accounting treatment of (i) its vehicles and (ii) its land with reference to relevant International Financial Reporting Standards.
- (i) Vehicles (8 marks)
 - (ii) Land (7 marks)
- (b) Discuss the impact which the mixed measurement approach may have on the analysis of financial statements by investors. (8 marks)

Professional marks will be awarded in Part (b) for clarity and quality of presentation.

(2 marks)

(Total = 25 marks)

4 Rationale Co

The directors of Rationale Co are reviewing the published financial statements of the group which include performance measures, such as 'underlying profit'. This information is additional to that which is required by IFRS Standards.

The following exhibit provides information relevant to the question.

Exhibit 1 – Financial statement extract

The following is an extract of information to be found in the financial statements.

Year ended		31 December 20X6 \$m	31 December 20X5 \$m
Net profit/(loss) before taxation and after the items set out below		(5)	38
Net interest expense		10	4
Depreciation		9	8
Amortisation of intangible assets		3	2
Impairment of property	10		
Insurance recovery	(7)		
		3	
Debt issue costs		2	
Share-based payment		3	1
Restructuring charges		4	
Impairment of acquired intangible assets		6	8

The directors use 'underlying profit' to comment on its financial performance. Underlying profit is a measure normally based on earnings before interest, tax, depreciation and amortisation (EBITDA). However, the effects of events which are not part of the usual business activity are also excluded when evaluating performance.

The following items were excluded from net profit to arrive at 'underlying profit'. In 20X6, Rationale Co had to write off a property due to subsidence and the insurance recovery for this property was recorded but not approved until 20X7, when the company's insurer concluded that the claim was valid. In 20X6, Rationale Co considered issuing loan notes to finance an asset purchase, however, the purchase did not go ahead. Rationale Co incurred costs associated with the potential issue and so these costs were expensed as part of net profit before taxation. The directors of Rationale Co felt that the share-based payment was not a cash expense and that the value of the options was subjective. Therefore, the directors wished to exclude the item from 'underlying profit'. Similarly, they wish to exclude restructuring charges incurred in the year, and impairments of acquired intangible assets.

Required

- (a) (i) Discuss the possible concerns where an entity may wish to disclose information that is in addition to that required by IFRS standards in its financial statements and whether the *Conceptual Framework for Financial Reporting (2018)* helps in determining the boundaries for disclosure. (8 marks)
- (ii) Discuss the use and the limitations of the proposed calculation of 'underlying profit' by Rationale Co.

Note. Your answer should include a comparative calculation of underlying profit for the years ended 31 December 20X5 and 20X6. (9 marks)

- (b) The directors of Rationale Co are confused over the nature of a reclassification adjustment. Discuss, with examples, the nature of a reclassification adjustment and the arguments for and against allowing reclassification of items to profit or loss.

Note. A brief reference should be made in your answer to the *Conceptual Framework for Financial Reporting (2018)*. (8 marks)

(Total = 25 marks)



Answers

DO NOT TURN THIS PAGE UNTIL YOU HAVE
COMPLETED THE MOCK EXAM



Section A

1 Kutchen Co

Marking scheme

		Marks
(a)	Application of the following discussion to the scenario:	
	• Contingent consideration	2
	• NCI	2
	• Fair value of assets acquired	2
	Goodwill calculations and corrections required	<u>4</u>
		10
(b)	Application of the following discussion to the scenario:	
	• Proceeds	1
	• Carrying amount of the assets disposed of	2
	Calculation of the gain/loss on disposal of Niche Co	<u>2</u>
		5
(c)	Application of the following discussion to the scenario:	
	• Present value and past service cost	2
	• Calculation of SOPL effect	3
	• Consideration of a restructuring provision	<u>2</u>
		7
(d)	Application of the following discussion to the scenario:	
	• Definition of a liability and IAS 32 (liability vs equity)	2
	• Definition of equity	2
	• Consideration of contingent payments of Mach Co	<u>4</u>
		<u>8</u>
		<u>30</u>

- (a) Goodwill on the acquisition of House Co and Mach Co should have been calculated as follows.

House Co

	\$m	\$m
Fair value of consideration for 70% interest	42.00	
Fair value of non-controlling interest	16.38	58.38
Fair value of identifiable net assets acquired		<u>(48.00)</u>
Goodwill		<u>10.38</u>

The goodwill calculation should be done in the **spreadsheet response option**, in which you can make use of a formula to add up the calculation:

The formula in cell B7 is =SUM(B4:B6) which sums the cells B4 to B6.
Or you could use this formula: =B4+B5+B6

Contingent consideration should be valued at fair value and will have to take into account the various milestones set under the agreement. The expected value is $(20\% \times 5 \text{ million shares}) 1 \text{ million shares} \times \$2$, ie \$2 million. There will be no remeasurement of the fair value in subsequent periods because the amount is settled in equity. If this were a liability, there would be remeasurement. The contingent consideration will be shown in OCE. The fair value of the consideration is therefore 20 million shares at \$2 plus \$2 million (above), ie \$42 million.

The finance director has not taken into account the fair value of the NCI in the valuation of goodwill or the contingent consideration. If the difference between the fair value of the consideration, NCI and the identifiable net assets is negative, the resulting gain is a bargain purchase in profit or loss, which may arise in circumstances such as a forced seller acting under compulsion. However, before any bargain purchase gain is recognised in profit or loss, and hence in retained earnings in the group statement of financial position, the finance director should have undertaken a review to ensure the identification of assets and liabilities is complete, and that measurements appropriately reflect consideration of all available information.

Debit	Goodwill	\$10.38 million	
Debit	Profit or loss	\$8 million	
Credit	NCI		\$16.38 million
Credit	OCE		\$2 million

Mach Co

Net profit of Mach Co for the year to 31 December 20X5 is \$3.6 million. The P/E ratio (adjusted) is 19. Therefore, the fair value of Mach Co is $19 \times \$3.6$ million, ie \$68.4 million. The NCI has a 20% holding; therefore, the fair value of the NCI is \$13.68 million.

	\$m	\$m
Fair value of consideration for 80% interest (\$52m + \$5m)	57.00	
Fair value of non-controlling interest	<u>13.68</u>	70.68
Fair value of identifiable net assets acquired		<u>(55.00)</u>
Goodwill		<u>15.68</u>

The land transferred as part of the purchase consideration should be valued at its acquisition date fair value of \$5 million and included in the goodwill calculation. Therefore, the increase of \$2 million over the carrying amount should be shown in retained earnings.

Debit	PPE	\$2 million	
Credit	Retained earnings		\$2 million

The adjustment to the group financial statements would be as follows:

Debit	Goodwill	\$15.68 million	
Debit	Retained earnings	\$3 million	
Credit	NCI		\$13.68 million
Credit	PPE		\$5 million

Total goodwill is therefore \$(15.68 + 10.38) million, ie \$26.06 million.

(b) Niche Co

The finance director had calculated that a gain arose of \$2 million on the sale of Niche Co in the group financial statements being the sale proceeds of \$50 million less \$48 million which is their share of the identifiable net assets at the date of sale (80% of \$60 million). However, the calculation of the gain or loss on sale should have been the difference between the carrying amount of the net assets (including any unimpaired goodwill) disposed of and any proceeds received. The calculation of net assets will include the appropriate portion of cumulative exchange differences and any other amounts recognised in other comprehensive income and accumulated in equity. Additionally, the loss on sale should have been reported as a loss in profit or loss attributable to the parent.

The gain on the sale of Niche Co should have been recorded as follows:

	\$m
Gain/(Loss) in group financial statements on sale of Niche Co	
Sale proceeds	50.0
Less	
Share of identifiable net assets at date of disposal ($80\% \times \$60$ million)	(48.0)
Goodwill $\$(40\text{m} - (80\% \text{ of } \$44\text{m}) - \text{impairment } \$2\text{m})$	<u>(2.8)</u>
Loss on sale of Niche Co recognised in group profit or loss	<u>(0.8)</u>

- (c) After restructuring, the present value of the pension liability in location 1 is reduced to \$8 million. Thus, there will be a negative past service cost in this location of \$(10 - 8) million, ie \$2 million. As regards location 2, there is a settlement and a curtailment as all liability will be extinguished by the payment of \$4 million. Therefore, there is a loss of \$(2.4 - 4) million, ie \$1.6 million. The changes to the pension scheme in locations 1 and 2 will both affect profit or loss as follows:

Location 1

Debit	Pension obligation	\$2m	
Credit	Retained earnings		\$2m

Location 2

Debit	Pension obligation	\$2.4m	
Debit	Retained earnings	\$1.6m	
Credit	Current liabilities		\$4m

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that a provision for restructuring should be made only when a detailed formal plan is in place and the entity has started to implement the plan, or announced its main features to those affected. A board decision is insufficient. Even though there has been no formal announcement of the restructuring, Kutchen Co has started implementing it and therefore it must be accounted for under IAS 37.

A provision of \$6 million should also be made at the year end.

- (d) The *Conceptual Framework* defines a liability as a present obligation, arising from past events for which there is an expected outflow of economic benefits. IAS 32 *Financial Instruments: Presentation* establishes principles for presenting financial instruments as liabilities or equity. IAS 32 does not classify a financial instrument as equity or financial liability on the basis of its legal form but on the substance of the transaction. The key feature of a financial liability is that the issuer is obliged to deliver either cash or another financial asset to the holder. An obligation may arise from a requirement to repay principal or interest or dividends.

In contrast, equity has a residual interest in the entity's assets after deducting all of its liabilities. An equity instrument includes no obligation to deliver cash or another financial asset to another entity. A contract which will be settled by the entity receiving or delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. However, if there is any variability in the amount of cash or own equity instruments which will be delivered or received, then such a contract is a financial asset or liability as applicable.

The contingent payments should not be treated as contingent liabilities but they should be recognised as financial liabilities and measured at fair value at initial recognition. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* excludes from its scope contracts which are executory in nature, and therefore prevents the recognition of a liability. Additionally, there is no onerous contract in this scenario.

Contingent consideration for a business must be recognised at the time of acquisition, in accordance with IFRS 3 *Business Combinations*. However, IFRSs do not contain any guidance when accounting for contingent consideration for the acquisition of a NCI in a subsidiary. The contract for contingent payments does meet the definition of a financial liability under IAS 32. Kutchen Co has an obligation to pay cash to the vendor of the NCI under the terms of a contract. It is not within Kutchen Co's control to be able to avoid that obligation. The amount of the contingent payments depends on the profitability of Mach Co, which itself depends on a number of factors which are uncontrollable. IAS 32 states that a contingent obligation to pay cash which is outside the control of both parties to a contract meets the definition of a financial liability which shall be initially measured at fair value. Since the contingent payments relate to the acquisition of the NCI, the offsetting entry would be recognised directly in equity.