2 Abby Co

Marking scheme

		Marks
Application of the following discussion of accounting issues to the scenario:		
• Related party transactions	2	
• Competitive harm exemptions	2	
• Impairment of financial assets	2	
• Fair value adjustments	2	
• Goodwill impairment review	2	
Application of the following discussion of ethical issues to the scenario:		
• Potential breaches	4	
• Advice to accountant	4	
		18
Professional		2
		20

Related parties

The objective of IAS 24 *Related Party Disclosures* is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

If there have been transactions between related parties, there should be disclosure of the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. The director is a member of the key management personnel of the reporting entity and the entity from whom the goods were purchased is jointly controlled by that director. Therefore, a related party relationship exists and should be disclosed.

Operating segments

IFRS 8 *Operating Segments* requires an entity to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments which meet specified criteria.

IFRS 8 does not contain a 'competitive harm' exemption and requires entities to disclose the financial information which is provided by the chief operating decision maker (CODM). The management accounts reviewed by the CODM may contain commercially sensitive information, and IFRS 8 might require that information to be disclosed externally.

Under IFRS 8, firms should provide financial segment disclosures which enable investors to assess the different sources of risk and income as management does. This sensitive information would also be available for competitors. The potential competitive harm may encourage firms to withhold segment information.

However, this is contrary to IFRS 8 which requires information about the profit or loss for each reportable segment, including certain specified revenues and expenses such as revenue from external customers and from transactions with other segments, interest revenue and expense, depreciation and amortisation, income tax expense or income and material non-cash items.

Impairment of financial assets

Areas such as impairments of financial assets often involve the application of professional judgement. The director may have received additional information, which has allowed him to form a different opinion to that of the accountant. The matter should be discussed with the director to ascertain why no provision is required and to ask whether there is additional information available.

However, suspicion is raised by the fact that the accountant has been told not to discuss the matter. Whilst there may be valid reasons for this, it appears again that the related party relationship is affecting the judgement of the director.

Fair value adjustments

Positive fair value adjustments increase the assets of the acquired company and as such reduce the goodwill recognised on consolidation. However, the majority of positive fair value adjustments usually relate to items of property, plant and equipment.

As a result, extra depreciation based on the net fair value adjustment reduces the post-acquisition profits of the subsidiary. This has a negative impact on important financial performance measures such as EPS. Therefore, by reducing fair value adjustments it will improve the apparent performance of new acquisitions and the consolidated financial statements.

Accountants should act ethically and ignore undue pressure to undertake creative accounting in preparing such adjustments. Guidance such as IFRS 3 *Business Combinations* and IFRS 13 *Fair Value Measurement* should be used in preparing adjustments and professional valuers should be engaged where necessary.

Impairment tests

In measuring value in use, the discount rate used should be the pre-tax rate which reflects current market assessments of the time value of money and the risks specific to the asset.

The discount rate should not reflect risks for which future cash flows have been adjusted and should equal the rate of return which investors would require if they were to choose an investment which would generate cash flows equivalent to those expected from the asset.

By reducing the impairment, it would have a positive impact on the financial statements. The offer of a salary increase is inappropriate and no action should be taken until the situation is clarified. Inappropriate financial reporting raises issues and risks for those involved and others associated with the company. Whilst financial reporting involves judgement, it would appear that this situation is not related to judgement.

Ethical issues

There are several potential breaches of accounting standards and unethical practices being used by the director. The director is trying to coerce the accountant into acting unethically.

IAS 1 requires all IFRS Standards to be applied if fair presentation is to be obtained. Directors cannot choose which standards they do or do not apply.

It is important that accountants identify issues of unethical practice and act appropriately in accordance with ACCA's *Code of Ethics*. The accountant should discuss the matters with the director. The technical issues should be explained and the risks of non-compliance explained to the director. If the director refuses to comply with accounting standards, then it would be appropriate to discuss the matter with others affected such as other directors and seek professional advice from ACCA. Legal advice should be considered if necessary.

An accountant who comes under pressure from senior colleagues to make inappropriate valuations and disclosures should discuss the matter with the person suggesting this. The discussion should try to confirm the facts and the reporting guidance which needs to be followed.

Financial reporting does involve judgement but the cases above seem to be more than just differences in opinion. The accountant should keep a record of conversations and actions and discuss the matters with others affected by the decision, such as directors. Additionally, resignation should be considered if the matters cannot be satisfactorily resolved.

Section B

3 Africant Co

Marking scheme

				Marks
(a)	(i)	Discussion of the principles of IFRS 13	4	
		Application of the IFRS 13 principles to Africant Co	4	
				8
	(ii)	Market perspective and highest and best use	4	
		Application of highest and best use to Africant Co	3	
				7
(b)	Single vs mixed measurement and investor issues		2	
	Examples		2	
	Investor issues re uncertainty		2	
	Investor issues re price volatility		2	
				8
Professional				2
				25

(a) (i) IFRS *13 Fair Value Measurement* says that fair value is an exit price in the principal market, which is the market with the highest volume and level of activity. It is not determined based on the volume or level of activity of the reporting entity's transactions in a particular market.

Once the accessible markets are identified, market-based volume and activity determines the principal market. There is a presumption that the principal market is the one in which the entity would normally enter into a transaction to sell the asset or transfer the liability, unless there is evidence to the contrary.

In practice, an entity would first consider the markets it can access. In the absence of a principal market, it is assumed that the transaction would occur in the most advantageous market. This is the market which would maximise the amount which would be received to sell an asset or minimise the amount which would be paid to transfer a liability, taking into consideration transport and transaction costs.

In either case, the entity must have access to the market on the measurement date. Although an entity must be able to access the market at the measurement date, IFRS 13 does not require an entity to be able to sell the particular asset or transfer the particular liability on that date.

If there is a principal market for the asset or liability, the fair value measurement represents the price in that market at the measurement date regardless of whether that price is directly observable or estimated using another valuation technique and even if the price in a different market is potentially more advantageous.

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

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

The IASB decided to prioritise the price in the most liquid market (ie the principal market) as this market provides the most reliable price to determine fair value and also serves to increase consistency among reporting entities.

IFRS 13 makes it clear that the price used to measure fair value must not be adjusted for transaction costs, but should consider transportation costs.

Africant Co has currently deducted transaction costs in its valuation of the vehicles. Transaction costs are not deemed to be a characteristic of an asset or a liability but they are specific to a transaction and will differ depending on how an entity enters into a transaction.

While not deducted from fair value, an entity considers transaction costs in the context of determining the most advantageous market because the entity is seeking to determine the market which would maximise the net amount which would be received for the asset.

(ii) A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant who would use the asset in its highest and best use.

The maximum value of a non-financial asset may arise from its use in combination with other assets or by itself.

IFRS 13 requires the entity to consider uses which are physically possible, legally permissible and financially feasible. The use must not be legally prohibited. For example, if the land is protected in some way by law and a change of law is required, then it cannot be the highest and best use of the land.

In this case, Africant Co's land for residential development would only require approval from the regulatory authority and as that approval seems to be possible, then this alternative use could be deemed to be legally permissible. Market participants would consider the probability, extent and timing of the approval which may be required in assessing whether a change in the legal use of the non-financial asset could be obtained.

Africant Co would need to have sufficient evidence to support its assumption about the potential for an alternative use, particularly in light of IFRS 13's presumption that the highest and best use is an asset's current use.

Africant Co's belief that planning permission was possible is unlikely to be sufficient evidence that the change of use is legally permissible. However, the fact the government has indicated that more agricultural land should be released for residential purposes may provide additional evidence as to the likelihood that the land being measured should be based upon residential value. Africant Co would need to prove that market participants would consider residential use of the land to be legally permissible.

Provided there is sufficient evidence to support these assertions, alternative uses, for example, commercial development which would enable market participants to maximise value, should be considered, but a search for potential alternative uses need not be exhaustive.

In addition, any costs to transform the land, for example, obtaining planning permission or converting the land to its alternative use, and profit expectations from a market participant's perspective should also be considered in the fair value measurement.

If there are multiple types of market participants who would use the asset differently, these alternative scenarios must be considered before concluding on the asset's highest and best use.

It appears that Africant Co is not certain about what constitutes the highest and best use and therefore IFRS 13's presumption that the highest and best use is an asset's current use appears to be valid at this stage.

(b) A measurement basis must be selected for each element recognised in the financial statements. The *Conceptual Framework* describes the characteristics of historical cost and current value (including fair value) measurement bases and when it may be appropriate to use each basis.

Some investors may be in favour of a **single measurement basis** for all recognised assets and liabilities arguing that the resulting totals and subtotals can have little meaning if different measurement methods are used.

Similarly, they may argue that profit or loss may lack relevance if it reflects a combination of flows based on historical cost and of value changes for items measured on a current value basis.

However, the majority of investors would tend to prefer that the most **relevant measurement method** is selected for each category of assets and liabilities. This is known as a **mixed measurement** approach and is consistent with how investors analyse financial statements.

The *Conceptual Framework* requires selection of a measurement basis that provides the most useful information to primary users, subject to the cost constraint. Therefore, it supports a mixed measurement basis as consideration of these factors is likely to result in the selection of different measurement bases for different items.

The problems of mixed measurement are outweighed by the **greater relevance achieved** if the most relevant measurement basis is used for each class of assets and liabilities. The mixed measurement approach is reflected in the most recently issued standards. For example IFRS 9 *Financial Instruments* requires the use of cost in some cases and fair value in other cases. While IFRS 15 *Revenue from Contracts with Customers* essentially applies cost allocation.

Most accounting measures of assets and liabilities are uncertain and require estimation. While some measures of historical cost are straightforward as it is the amount paid or received, there are many occasions when the measurement of cost can be uncertain. In particular, recoverable cost, for which impairment and depreciation estimates are required.

In a similar vein, while some measures of fair value can be easily observed because of the availability of prices in an actively traded market (a so-called 'Level 1' fair value), others inevitably rely on management estimates and judgements ('Level 2' and 'Level 3').

High measurement uncertainty may mean that the measurement basis selected does not produce a faithful representation of the entity's financial position and financial performance. In such cases, selecting a slightly less relevant measurement basis but with less measurement uncertainty may provide more useful information to investors.

If a relevant measure of an asset or liability value is volatile, this should not be hidden from investors. To conceal its volatility would decrease the usefulness of the financial statements. Of course, such volatile gains and losses do need to be clearly presented and disclosed, because their predictive value may differ from that provided by other components of performance.

4 Rationale Co

Marking scheme

				Marks
(a)	(i)	Discussion of additional disclosure issues	4	
		Conceptual Framework and general purpose financial statements	4	
				8
	(ii)	The potential use, misuse and manipulation of EBITDA	3	
		Application of use/misuse of EBITDA by Rationale	2	
		Calculation of underlying profit of Rationale	4	
				9
(b)		The nature of a reclassification adjustment	1	
		Examples	2	
		Arguments for and against reclassification	5	
				8
				25

(a) (i) There is no specific guidance on the disclosure of additional information which is not specifically required by an IFRS Standard. IFRS Standards require an entity to disclose additional information which is relevant to an understanding of the entity's financial position and financial performance.

A company may disclose additional information where it is felt that its performance may not be apparent from its financial statements prepared under IFRS Standards. A single standardised set of financial statements can never provide sufficient information to understand an entity's position or performance. Additional information can help users understand management's view of what is important to the entity and the nature of management's decisions.

However, there are concerns relating to the disclosure of additional information:

- Such information may not readily be derived or reconciled back to the financial statements.
- There may be difficulty comparing information across periods and between entities because of the lack of a standardised approach.
- The presentation of additional information may be inconsistent with that defined or specified in IFRS Standards and the entity may present an excessively optimistic picture of an entity's financial performance.
- Non-IFRS information may make it difficult to identify the complete set of financial statements, including whether the information is audited or not.
- Non-IFRS information may be given undue prominence or credibility merely because of its location within the financial statements.

Disclosure boundaries are not specifically defined in IFRS Standards, but they do derive from the objective of financial statements. According to the *Conceptual Framework*, the objective of financial statements is to provide financial information about an entity's assets, liabilities, equity, income and expenses which is useful to users of financial statements in assessing the prospects for future net cash inflows to the entity and in assessing management's stewardship of the entity's resources. As a result, financial statements provide information about an entity's assets, liabilities and equity which existed at the end of the reporting period and about income and expenses which arose during the reporting period. It is directed at users who provide resources to the reporting entity but lack the ability to compel the entity to provide them with the information which they need. The *Conceptual Framework* limits the range of addressees of general-purpose financial statements to existing or potential investors, lenders and other creditors. The *Conceptual Framework* acknowledges that general-purpose financial statements may not provide information which serves all users' needs.

(ii) The directors of Rationale Co are utilising a controversial figure for evaluating the company's performance. Depreciation and amortisation are non-cash expenses related to assets which have already been purchased and they are expenses which are subject to judgement or estimates based on experience and projections. The company, by using EBITDA, is attempting to show operating cash flow since the non-cash expenses are added back.

EBITDA can often be misused and manipulated. It can be argued that because the estimation of depreciation, amortisation and other non-cash items is vulnerable to judgement error, the profit figure can be distorted but by focusing on profits before these elements are deducted, a truer estimation of cash flow can be given. However, the substitution of EBITDA for conventional profit fails to take into account the need for investment in fixed capital items.

There can be an argument for excluding non-recurring items from the net profit figure. Therefore, it is understandable that the deductions for the impairment of property, the insurance recovery and the debt issue costs are made to arrive at 'underlying profit'. However, IAS 1 *Presentation of Financial Statements* states that 'an entity shall present additional line items, headings and subtotals in the statements presenting profit and loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance' (para. 55). This paragraph should not be used to justify presentation of underlying, adjusted and pre-exceptional measures of performance on the face of the statement of profit or loss. The measures proposed are entity specific and could obscure performance and poor management.

Stock-based compensation may not represent cash but if an entity chooses to pay equity to an employee that affects the value of equity, no matter what form that payment is in and therefore it should be charged as employee compensation. It is an outlay in the form of equity. There is therefore little justification in excluding this expense from net profit. Restructuring charges are a feature of an entity's business and they can be volatile. They should not be excluded from net profit because they are part of corporate life. Severance costs and legal fees are not non-cash items.

Impairments of acquired intangible assets usually reflect a weaker outlook for an acquired business than was expected at the time of the acquisition, and could be considered to be non-recurring. However, the impairment charges are a useful way of holding management accountable for its acquisitions. In this case, it seems as though Rationale Co has not purchased wisely in 20X6.

It appears as though Rationale Co wishes to disguise a weak performance in 20X6 by adding back a series of expense items. EBITDA, although reduced significantly from 20X5, is now a positive figure and there is an underlying profit created as opposed to a loss. However, users will still be faced with a significant decline in profit whichever measure is disclosed by Rationale Co. The logic for the increase in profit is flawed in many cases but there is a lack of authoritative guidance in the area. Many companies adopt non-financial measures without articulating the relationship between the measures and the financial statements.

Year ended	*31 December 20X6*	*31 December 20X5*
	$m	$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
EBITDA	17	52
Impairment of property	10	
Insurance recovery	(7)	–
Debt issue costs	2	–
EBITDA after non-recurring items	22	52
Share-based payment	3	1
Restructuring charges	4	
Impairment of acquired intangible assets	6	8
Underlying profit	35	61

Tutorial note

The recalculation of underlying profit is best answered using the **spreadsheet response option,** in which you can make use of formulas to add up the columns:

Spreadsheet

Edit Format

100%

11

B3			
	A	B	C
1	(a)(i)		
2	**Working 1 Underlying profit**		
3	Year ended	31-Dec	31-Dec
4		20X6	20X5
5		$m	$m
6	Net profit/(loss) before taxation and after the items set out below	-5	38
7	Net interest expense	10	4
8	Depreciation	9	8
9	Amortisation of intangible assets	3	2
10	EBITDA	**17**	**52**
11	Impairment of property	10	
12	Insurance recovery	-7	
13	Debt issue costs	2	
14	EBITDA after non-recurring items	**22**	**52**
15	Share-based payment	3	1
16	Restructuring charges	4	
17	Impairment of acquired intangible assets	6	8
18	Underlying profit	**35**	**61**

Make sure you clearly reference your working

Remember to **clearly label your working.**

(b) Reclassification adjustments are amounts recycled to profit or loss in the current period which were recognised in OCI in the current or previous periods. An example of items recognised in OCI which may be reclassified to profit or loss are foreign currency gains on the disposal of a foreign operation and realised gains or losses on cash flow hedges. Those items which may not be reclassified are changes in a revaluation surplus under IAS 16 *Property, Plant and Equipment*, and actuarial gains and losses on a defined benefit plan under IAS 19 *Employee Benefits*. However, there is a general lack of agreement about which items should be presented in profit or loss and in OCI. The interaction between profit or loss and OCI is unclear, especially the notion of reclassification and when or which OCI items should be reclassified. A common misunderstanding is that the distinction is based upon realised versus unrealised gains.

There are several arguments for and against reclassification. If reclassification ceased, then there would be no need to define profit or loss, or any other total or subtotal in profit or loss, and any presentation decisions can be left to specific IFRS Standards. It is argued that reclassification protects the integrity of profit or loss and provides users with relevant information about a transaction which occurred in the period. Additionally, it can improve comparability where IFRS Standards permits similar items to be recognised in either profit or loss or OCI.

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

The lack of a consistent basis for determining how items should be presented has led to an inconsistent use of OCI in IFRS. Opinions vary but there is a feeling that OCI has become a home for anything controversial because of a lack of clear definition of what should be included in the statement. Many users are thought to ignore OCI, as the changes reported are not caused by the operating flows used for predictive purposes.

Chapter 7 of the *Conceptual Framework* contains guidance on reclassification. There is a presumption that if income and expenses are included in OCI in one period, that they will be reclassified in some future period when doing so enhances the relevance of the information or provides more faithful representation in that period. The presumption can be rebutted if there is no clear basis for identifying the period in which the reclassification would enhance the relevance of the information in the statement of profit or loss. This may indicate that the income or expense should not have been included in OCI originally. It can be argued that reclassification adjustments do not meet the definition of income and expenses in the period they occur and, therefore, those adjustments should be acknowledged as items which do not fulfil the definition of income and expense.

Tutorial note.

This part of the answer is best done in the word processor response option. Remember to use key text from the requirement as headings to break up your answer.

Word Processor

Paragraph

(b) **Nature of a reclassification adjustment**

Reclassification adjustments are amounts recycled to profit or loss in the current period that were recognised in other comprehensive income (OCI) in a previous period.

The Conceptual Framework states that there is a presumption that if income or expenses are included in OCI in one period they will be recycled to OCI in a future period when doing so provides more relevant information or a more faithful representation in that period.

This presumption can be rebutted if there is no clear basis for identifying the period in which the reclassification would enhance the relevance of the information.

Examples

- Foreign currency gains on the disposal on a foreign operation
- Realised gains or losses on cash flow hedges

Arguments for allowing reclassification

Some people argue that reclassification protects the integrity of profit or loss and provides users with relevant information about a transaction that occurred in the period.

Arguments against allowing reclassification

There is no clear basis in the Conceptual Framework as to when a gain or loss is presented in OCI instead of in profit or loss and when a gain/loss can be recycled.

This means that there is inconsistency between IFRS Standards as to when an item is presented in OCI and when items are recycled.

For example, revaluation gains on property, plant and equipment are recognised in OCI but are not reclassified when the item is disposed, but foreign currency gains on foreign operations previously recognised in OCI are recycled when the foreign operation is disposed of.

It can be argued that reclassification results in increased complexity of financial statements and so make it harder for users of financial statements to understand. The increased complexity could also make it easier for preparers to misclassify amounts in order to manage earnings.

ACCA

Strategic Business Reporting (International)

Mock Examination 3

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 Columbia Co

Columbia Co is the parent of a listed group which operates within the telecommunications industry. During the year ended 31 December 20X5 Columbia Co acquired a new subsidiary and made adjustments to its pension scheme. The group's current year end is 31 December 20X5.

The following exhibits provide information relevant to the question.

Exhibit 1 - Acquisition of Peru Co

Brazil Co is a competitor of Columbia Co. On 1 July 20X5 both Brazil Co and Columbia Co acquired 50% of the 5 million ordinary $1 shares of Peru Co. The consideration paid by Columbia Co consisted of cash of $8 per share and also a 1 for 20 share exchange when the market price of Columbia Co's shares was $10 each. Brazil Co also paid $8 per share for their interest but did not issue any shares to the original shareholders of Peru Co. The ordinary shares of Peru Co have one voting right each.

Following the acquisition, Columbia Co had the contractual right to appoint 60% o the board of Peru Co with the remaining 40% appointed by Brazil Co. Brazil Co has veto rights over any amendments to the articles of incorporation and also over the appointment of auditors. Brazil Co and Columbia Co each appointed one member to Peru Co's senior management team. It is the senior manager appointed by Columbia Co who makes the key decisions regarding the development of Peru Co's new technologies, its principal revenue stream, the markets that it will operate in and how it is financed. The senior manager appointed by Columbia Co also provides a supervisory role and has the right to request that significant activities get board approval, such as imposing restrictions on Peru Co from undertaking activities that would significantly increase credit risk.

Exhibit 2 - Peru Co: net assets at 1 July 20X5

The net assets of Peru Co reported in the individual financial statements had a carrying amount of $32 million on 1 July 20X5. However, on the acquisition of Peru Co, the directors of Columbia Co discovered the following:

On 1 January 20X5 Peru Co acquired 6 million 6% coupon bonds for $6 million in an unquoted company at par ($1). Bond interest is paid annually on 31 December. Due to a premium on redemption the effective rate of interest was 8%. Peru Co has a business model to collect the contractual cash-flows from the bonds and therefore measures them at amortised cost. Columbia Co holds similar unquoted assets but has a business model whereby they may either collect the contractual cash-flows or sell the asset. Bonds with a similar risk profile for a similar quoted company were trading at $2 per bond on 1 July 20X5. A discount of 30% is considered reasonable to reflect the difference in liquidity of the two types of bonds.

One of the identifiable intangible assets of Peru Co at acquisition was a brand. The brand had a carrying amount of $4 million on 1 July 20X5. Columbia Co has a similar branded product and is therefore planning to discontinue the trade of Peru Co's branded product with immediate effect. The future cash-flows from the Peru Co's product post-acquisition are therefore considered to be $nil. If the trade of the branded product were to be sold to a competitor in order to continue the trade, it is estimated that it could be sold for around $5 million.

Peru Co has several technical support service contracts for which there are outstanding performance obligations at 1 July 20X5. Included in contract liability (deferred income) at this date is a balance of $2.8 million in respect of these contracts. It is estimated that these contracts will cost $1.7 million for Peru co (and any other market participants) to complete. A mark-up of 30% is considered reasonable for this type of contract.

Columbia Co has a policy of measuring the non-controlling interest at fair value.

Exhibit 3 - Columbia Co: pension scheme

Columbia Co has, for many years, operated a defined benefit pension scheme. At 1 January 20X5 the fair value of the pension scheme assets were estimated to be $260 million and the present value of the pension scheme liabilities were $200 million. The total of the present value of future refunds and reductions in future contributions (asset ceiling) was $20 million at 1 January 20X5.

This table provides details of the scheme for the year ended 31 December 20X5 when there was a curtailment to the scheme.

Discount rate on good quality corporate bonds: 5%

	$(millions)
Current service cost	30
Cash contributions	21
Benefits paid during the year	25
Scheme curtailment (31 December 20X5)	28
Payment to employees as settlement for curtailment (paid 31 December 20X5)	16

At 31 December 20X5 the fair value of the pension scheme assets were estimated to be $242 million and the present value of the pension scheme liabilities were $195 million. The total of the present value of future refunds and reductions in future contributions (asset ceiling) was $25 million at 31 December 20X5.

Columbia Co intends all new employees to be offered a defined contribution rather than a defined benefit pension scheme. Contributions of $0.5 million were paid into a defined contribution scheme for new employees over the last 3 months of the year.

Required

Draft an explanatory note to the directors of Columbia Co to address the following issues:

(a) (i) whether Columbia Co should be considered the acquirer in a business combination with Peru Co; **(9 marks)**

(ii) a calculation of goodwill at 1 July 20X5, explaining how fair values of both the consideration and the net assets have been determined; and **(11 marks)**

(b) how the defined benefit and the defined contribution pension schemes should be accounted for in the year ended 31 December 20X5. **(10 marks)**

(Total = 30 marks)

2 Bismuth Co

Bismuth Co is a mining company. Investors in Bismuth Co receive earnings from mining projects as a return on their investment. The year end is 31 December 20X7.

The following exhibits provide information relevant to the question.

Exhibit 1 - Impairment testing of mines

At 31 December 20X7, Bismuth Co owns mines which have a carrying amount of $200 million. The company has committed itself to decommissioning its mines at the end of their useful life (five years or less) and has created a decommissioning provision of $53 million. However, the directors are unsure how the decommissioning provision will impact on the impairment testing of the mines. At the end of the useful life of a mine, its reusable components will be dismantled and sold.

The following information relates to the decommissioning of the mines at 31 December 20X7:

	$ million
Carrying amount of decommissioning provision	53
Present value of future cash inflows from:	
sale of reusable components at decommission date (inflows)	20
sale of mining output from 31 December 20X7 to decommission date (inflows)	203
operating costs from 31 December 20X7 to decommission date (outflows)	48

Exhibit 2 - Class A and B shares

Bismuth Co has issued two classes of shares, class A and class B, in exchange for a cryptocurrency, Bitcoin. Both types of shares permit the holder to vote and give an entitlement to 'rewards'. Bismuth Co has discretion over whether 'rewards' are payable on class A and class B shares. Bitcoin can be readily converted into cash in Bismuth Co's jurisdiction.

Class A shares are redeemable at par in the event of Bismuth Co obtaining a listing on a formal stock exchange which is highly probable. On listing, Bismuth Co has a choice as to the method of redemption either:

(i) cash to the value of 1 Bitcoin per 1000 class A shares, or
(ii) shares to the value of 2 Bitcoins per 1000 class A shares.

Note. 1 Bitcoin equates to approximately $12,000

The share settlement option, option (ii) above, would involve exchanging class A shares for the equivalent number of class B shares. Class B shares have never fluctuated in value.

Bismuth Co is not compelled to redeem the class B shares but these shares do contain an option allowing Bismuth Co to repurchase them. However, if within two years, Bismuth Co fails to exercise its call option on the class B shares, it must pay an additional reward to the holders of class B shares.

Exhibit 3 - Blockchain technology

Bismuth Co plans to implement Blockchain technology to store all of its data relating to its mines, trading and to certify the ethical sourcing of all its raw materials. The chief accountant, Ms Pleasant, is currently developing a blockchain technology that will be filed for patent. Ms Pleasant has only recently taken up the post and has discovered that work done at her previous employer, Gypsam Co, is relevant to the project. If Ms Pleasant discloses this information, it will compromise a patent process at Gypsam Co but will consolidate her position as chief accountant in Bismuth Co. When she left the employment of Gypsam Co, she signed a confidentiality agreement but the clauses were not clear or specific about what information could be shared and with whom.

Ms Pleasant has significant knowledge of Blockchain technology but the finance director, Mr Fricklin has limited knowledge of it or the new business model that Bismuth Co is trying to develop. Mr Fricklin has told her that there is no need to spend a significant amount of time creating a technology to ethically source materials. Ms Pleasant is worried about Mr Fricklin's lack of technical and legal knowledge as she feels that it will affect the development of the technology. In addition, some of the data concerning ethically sourced materials has gone missing and she thinks that Mr Fricklin has erased the data to try and sabotage the project. Mr Fricklin has told the Board of Directors that he has an 'in depth knowledge' of the technology.

Required

(a) Discuss, with suitable calculations, whether Bismuth Co should recognise an impairment loss for the mines. **(5 marks)**

(b) Discuss whether the class A and B shares should be classified as either equity or liability in accordance with IAS 32 *Financial Instruments: Presentation.* **(5 marks)**

(c) Discuss the ethical issues raised by the implementation of the blockchain technology for both the chief accountant and the finance director, including any appropriate actions which should be considered to resolve these issues. **(8 marks)**

Professional marks will be awarded in part (c) for the quality of the discussion. **(2 marks)**

(Total = 20 marks)

Section B – BOTH questions are compulsory and MUST be attempted

3 Sitka Co

Sitka Co is a software development company which operates in an industry where technologies change rapidly. Its customers use the cloud to access the software and Sitka Co generates revenue by charging customers for the software license and software updates. It has recently disposed of an interest in a subsidiary, Marlett Co, and purchased a controlling interest in Billing Co. The year end of the company is 31 December 20X7

The following exhibits provide information relevant to the question.

Exhibit 1 - Software contract and updates

On 1 January 20X7, Sitka Co agreed a four-year contract with Cent Co to provide access to licence Sitka Co's software including customer support in the form of monthly updates to the software.

The total contract price is $3 million for both licensing the software and the monthly updates. Sitka Co licenses the software on a stand-alone basis for between $1 million and $2 million over a four-year period and regularly sells the monthly updates separately for $2.5 million over the same period. The software can function on its own without the updates. Although, the monthly updates improve its effectiveness, they are not essential to its functionality. However, because of the rapidly changing technology in the industry, if Cent Co does not update the software regularly, the benefits of using the software would be significantly reduced. In the year to 31 December 20X7, Cent Co has only updated the software on two occasions. Cent Co must access the software via the cloud and does not own the rights to the software.

Exhibit 2 - Part-disposal of Marlett Co

Sitka Co prepares separate financial statements in accordance with IAS 27 Separate Financial Statements. At 31 December 20X6, it held a 60% controlling equity interest in Marlett Co and accounted for Marlett Co as a subsidiary. In its separate financial statements, Sitka Co had elected to measure its investment in Marlett Co using the equity method. On 1 July 20X7, Sitka Co disposed of 45% of its equity interest in Marlett Co for $10 million and lost control. At the date of disposal, the carrying amount of Marlett Co in its separate financial statements was $12 million. After the partial disposal, Sitka Co does not have joint control of, or significant influence over Marlett Co and its retained interest of 15% is to be treated as an investment in an equity instrument.

At 1 July 20X7, the fair value of the retained interest of 15% in Marlett Co was $3.5 million. Sitka Co wishes to recognise any profit or loss on the disposal of the 45% interest in other comprehensive income.

Exhibit 3 - Acquisition of Billing Co

Sitka Co has acquired two assets in a business combination with Billing Co. The first asset is 'Qbooks' which is an accounting system developed by Billing Co for use with the second asset which is 'Best Cloud' software. The directors of Sitka Co believe that the fair value of the assets is higher if valued together rather than individually. If the assets were to be sold, there are two types of buyers that would be interested in purchasing the assets. One buyer group would be those who operate in the same industry and have similar assets. This group of buyers would eventually replace Qbooks with their own accounting system which would enhance the value of their assets. The fair values of the individual assets in the industry buyer group would be $30 million for Qbooks and $200 million for 'Best Cloud', therefore being $230 million in total.

Another type of buyer is the financial investor who would not have a substitute asset for Qbooks. They would licence Qbooks for its remaining life and commercialise the product. The indicated fair values for Qbooks and Best Cloud within the financial investor group are $50 million and $150 million, being $200 million in total.

Required

(a) (i) Discuss whether the four-year software contract with Cent Co is a single performance obligation in accordance with IFRS 15 *Revenue from Contracts with Customers* including how the revenue from the contract would be accounted for in Sitka Co's financial statements for the year ended 31 December 20X7. Your answer should include whether the revenue should be recognised at a point in time or over time. **(8 marks)**

(ii) Discuss briefly why the right to receive access to Sitka Co's software is unlikely to be accounted for as an intangible asset or a lease in Cent Co's financial statements. **(4 marks)**

(b) Discuss and demonstrate how the disposal of 45% interest and the retained interest of 15% in Marlett Co should be accounted for in the separate financial statements of Sitka Co at the date of disposal. **(9 marks)**

(c) Discuss how the two assets acquired on the acquisition of Billing Co should be valued in accordance IFRS 13 *Fair Value Measurement*. **(4 marks)**

(Total = 25 marks)

4 Colat Co — 49 mins

Colat Co manufactures aluminium products and operates in a region that has suffered a natural disaster on 1 November 20X7. There has been an increase in operating costs as the company had to replace a regional supplier with a more costly international supplier. The year-end of Colat Co is 31 December 20X7.

The following exhibits provide information relevant to the question.

Exhibit 1 - Non-current assets

As a result of the natural disaster, the share price of Colat Co has declined as a significant amount of non-current assets were destroyed, including the manufacturing facility. In addition, Colat Co has suffered reputational damage resulting in a decline in customer demand.

The non-current assets of Colat Co that were destroyed had a carrying amount of $250 million on 31 October 20X7 and the fair value of these non-current assets was $280 million based on an independent appraisal shortly before that date. In addition, Colat Co determined that a power plant will have to be closed and decommissioned earlier than previously expected. The remaining useful life of the power plant has reduced from 25 years to 8 years. Non-current assets are valued using the cost model.

Exhibit 2 - Other natural disaster consequences

Environmental damage and government compensation

Colat Co has, in the past, repaired minor environmental damage that it has caused but it has never suffered a natural disaster on this scale. There is no legal obligation for Colat Co to repair and restore damage caused by the disaster as this will be the responsibility of the government.

The government announced on 1 December 20X7 that there would be compensation of $50 million available to repair the environmental damage only and that companies should apply for the compensation by 31 December 20X7. By 1 March 20X8, when the financial statements were approved, Colat Co had only received an acknowledgement of their application but no approval.

Hedge of commodity price risk in aluminium

Colat Co hedges commodity price risk in aluminium and such transactions were classified as 'highly probable' in accordance with IFRS 9 *Financial Instruments*. However, the purchases which were considered highly probable prior to the natural disaster, are no longer expected to occur.

Potential insurance policy proceeds

Colat Co's insurance policy provides compensation for losses based on the fair value of non-current assets, any temporary relocation costs estimated at $2 million and any revenue lost during the two-month period from 1 November 20X7. At 31 December 20X7, it is unclear which events and costs are covered by insurance policies and significant uncertainty exists as to whether any compensation will be paid. Before the financial statements were approved, it was probable that the insurance claim for the loss of the non-current assets would be paid but no further information was available about other insured losses.

The insurance policy does not cover environmental damage which is the responsibility of the government.

Required

Investors need to understand a variety of factors when making an investment decision. The nature of the companies in which they are looking to invest is an important consideration, as is the need to incorporate sustainability factors into investment decisions.

(a) Discuss why sustainability has become an important aspect of the investors' analysis of companies.

Note. There is no requirement to refer to any exhibit when answering part (a).

(4 marks)

Professional marks will be awarded in part (a) for clarity and quality of discussion.

(2 marks)

(b) Discuss any events affecting Colat Co which might indicate that an impairment test ought to be conducted in accordance with IAS 36 Impairment of Non-Current Assets. **(3 marks)**

(c) Discuss how the following should be accounted for in the financial statements for the year ended 31 December 20X7:

(i) the destruction of the non-current assets and decommissioning of the power plant; **(4 marks)**

(ii) the cost of repairing the environmental damage and the potential receipt of government compensation; **(4 marks)**

(iii) the hedge of the commodity price risk in aluminium; and **(4 marks)**

(iv) the potential insurance policy proceeds. **(4 marks)**

(Total = 25 marks)

Answers

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

Section A

1 Columbia Co

Marking scheme

				Marks
(a)	(i)	Definition of control	1	
		Application of the following to the scenario:		
		Voting rights	2	
		Governance structure	2	
		Key management	2	
		Premium on consideration	2	
				9
	(ii)	IFRS 13 discussion	2	
		Application of IFRS 13 to the following:		
		– Bonds	2	
		– Brand	2	
		– Deferred income	2	
		Goodwill calculation	3	
				11
(b)		Discussion of defined benefit scheme and asset ceiling	4	
		Defined benefit calculations	5	
		Discussion of the defined contribution scheme	1	
				10
				30

(a) (i) An acquirer is the entity which has assumed control over another entity. In accordance with IFRS 10 *Consolidated Financial Statements*, an investor controls an investee where it has:

- Power over the investee;
- Exposure or rights to variable returns from its involvement with the investee;
- The ability to use its power over the investee to affect the amount of the investor's returns.

There are a significant number of factors to consider when determining which entity should be treated as the acquirer. The first factor to consider is the consideration transferred for the relative share of ownership. It may look at first that Columbia Co and Brazil Co have undertaken a joint venture where the two parties share control over the investee. This is because both Columbia Co and Brazil Co have paid an equal amount of $8 per share. Additionally, Columbia Co and Brazil Co have each obtained 50% of the equity interests and have equal voting rights of one vote per share. Both entities satisfy the criteria for rights to a variable return. However, a joint venture relies upon there being joint control over all the key operating and financing decisions of the entity. The scenario does not indicate that unanimous consent is required because decision-making responsibilities appear to be split between Columbia Co and Brazil Co.

A second factor to consider is who has the rights to appoint the majority of the governing body. Columbia Co can appoint 60% of the board suggesting they may be the acquirer. It is true that Brazil Co does have additional rights in terms of the power to veto amendments to the articles of incorporation and the appointment of auditors. In the assessment of control, it is important to consider whether these rights give Brazil Co power over the investee and whether it can use this power to affect their return. In this assessment, it is important to distinguish between substantive rights and protective rights. Only rights which are substantive are said to give the investor control. These rights are more likely to be considered protective since they appear to prohibit changes in the activities of the investee which Brazil Co does not agree with rather than give Brazil Co power. Additionally, these are not rights which would allow Brazil Co to affect the profitability of Peru Co and subsequently their return. Protective rights do not prevent Columbia Co from obtaining control.

A similar argument can be applied to the appointment of the senior managers. The entity which has the right to appoint the majority of the senior management team is more likely to be the acquirer. Whilst each entity can appoint one senior manager each, the rights of the senior management appointed by Brazil Co appear to be protective while all key decisions are made by the senior manager appointed by Columbia Co. The rights of the senior manager appointed by Columbia Co therefore appear substantive including requesting board approval for significant activities. They have the rights over decisions affecting the key revenue earning capabilities of Peru Co including technological development, markets to operate it and ways of raising finance. Thus, Columbia Co has power over the investee and these rights enable them to affect their return.

Further evidence that Columbia Co is the acquirer is reflected by the share issue which Columbia paid as additional consideration. To obtain control, it is often the case that the acquirer has to pay a premium on acquisition for their equity interests. Columbia Co has in effect had to pay additional consideration equal to $1.25 million (50% × $5 million × 1/20 × $10) despite each investor acquiring 50% of the equity shares. It can be concluded that Columbia is the acquirer in a business combination and that Brazil Co, in effect, is the non-controlling interest.

(ii) Goodwill at acquisition should be calculated as follows:

	$ millions	$ millions
Consideration		
– Cash (5m shares × 50% × $8)	20	
– Shares (5m shares × 50%/20 × $10)	1.25	21.25
Add fair value of non-controlling interest at acquisition (5m shares × 50% × $8)		20
Less net assets at acquisition – per question:	32	
Fair value adjustment – bonds (see below)	2.16	
Fair value adjustment – brand (see below)	1	
Fair value adjustment – deferred income (see below)	0.59	
		(35.75)
Goodwill at acquisition		5.5

Fair value per IFRS 13 *Fair Value Measurement* defines fair value as the price paid which would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This means that fair value is not entity specific but rather should take into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant who would use the asset in its highest and best use. Goodwill should be measured by deducting the fair value of the identifiable net assets at acquisition from the fair value (including any non-controlling interest) of the consideration paid.

In terms of the consideration paid by Columbia Co for the acquisition of Peru Co, the fair value of the cash paid will be equal to face value. Columbia Co has paid $8 per share for their 50% equity interest resulting in a cash consideration of $20 million (50% × 5 million × $8). The most reliable evidence of fair value is where an observable price for an identical asset or liability is traded on an active market. The fair value of Columbia Co's equity should therefore be measured using the market price of their own shares at the acquisition date of $10 per share. This results in a fair value measurement of \$1.25 million (50% × 5 million × 1/20 × \$10) for the share for share exchange.

Since the non-controlling interest is also to be measured at fair value and Brazil Co paid \$8 per share for their 50% equity interest, this will have a fair value of \$20 million.

In assessing the fair value of the identifiable net assets at acquisition, it is important that the net assets of Peru Co are measured using the same accounting policies of the group. Since Columbia Co has similar bonds where their business model is to either collect the cash flows or to sell, the bonds should be measured at their acquisition date fair values and treated as a fair value through other comprehensive income investment rather than amortised cost. The carrying amount of the bonds in the individual financial statements of Peru Co on 1 July 20X5 would be \$6.24 million (\$6 million + (6/12 × \$6 million × 8%)). Since the bonds are in an unquoted company and an active market for an identical asset is not observable, it appears reasonable to use the market value for a similar asset as adjusted for differences in their liquidity. The bonds would have a fair value of \$8.4 million (6 million × \$2 × 70%). A fair value uplift to the net assets of Peru Co of \$2.16 million (\$8.4 million – \$6.24 million) is required.

The fair value of the brand has to be determined in accordance with its highest and best use for market participants. Since it is not entity specific, the intention by Columbia Co to discontinue the brand is not relevant unless it is what other market participants would also do with the brand. Since it is estimated that a competitor would be prepared to pay \$5 million to continue the trade of the brand, this is not the case. The highest and best use of the brand from a market perspective would appear to be continue the trade at a value of \$5 million. A \$1 million increase is required to the fair value of the brand.

The deferred income must be measured from the market's perspective. Since the market would expect to incur direct and incremental costs of \$1.7 million in the performance of their obligations, the fair value should be determined by adding the 30% mark-up to this estimate. The fair value of the deferred income should be \$2.21 million (\$1.7 million × 130/100). This will result in a decrease in the liabilities at acquisition and therefore an increase in the net assets of Peru Co equal to \$590,000 (\$2.8 million – \$2.21 million).

(b) Where a defined benefit pension scheme is in surplus, IAS 19 *Employee Benefits* requires the surplus to be measured as the lower of:

- The surplus in the plan; and
- The present value of the economic benefits in the form of refunds from the plan or reductions in the future combinations (known as the asset ceiling).

At 1 January 20X5, the surplus of the scheme is \$60 million (\$260 million – \$200 million) but the asset ceiling is only \$20 million, so the defined benefit pension asset would have been restricted to \$20 million. Interest on the opening asset would therefore be adjusted and only \$1 million (5% × \$20 million) interest income will be recorded in profit or loss for the year. The cash contributions of \$21 million should be added to the scheme assets, benefits paid of \$25 million are deducted from both the scheme's assets and the scheme's liabilities and the current service cost of \$30 million is charged to profit or loss.

IAS 19 states that an entity must first determine any past service cost arising from a gain or loss on settlement without considering the effect on the asset ceiling. A gain therefore should be recognised in the profit or loss of Columbia Co on the settlement equal to \$12 million (\$28 million – \$16 million). The pension scheme surplus at 31 December 20X5 is summarised as follows.

	Assets $ millions	Liabilities $ millions	Net plan asset before ceiling adjustment $ millions	Ceiling adjustment $ millions	Net plan asset after ceiling adjustment $ millions
Balance 1 January 20X5	260	200	60	(40)	20
Net interest at 5%	13	10	3	(2)	1
Cash contributions	21		21		21
Benefits paid	(25)	(25)			
Current service cost		30	(30)		(30)
Curtailment and settlement	(16)	(28)	12		12
Total at 31 December 20X5	253	187	66	(42)	24

Tutorial note: *Candidates are not required to produce this table in its entirety and the detail provided here is for tutorial purposes only.*

The actuary has valued the scheme as a surplus of $47 million ($242 million – $195 million) immediately after the curtailment which would result in a remeasurement loss of $19 million ($66 million – $47 million) on 31 December 20X5. However, the effect of the asset ceiling is that the pension scheme would only be recognised at a value of $24 million following the curtailment (see table above). Since the scheme is valued at the lower of the surplus of the scheme and the present value of the economic benefits in the form of refunds from the plan or reductions in the future combinations, the scheme will be restated to $25 million. A net gain of $1 million ($25 million – $24 million) will be recognised in other comprehensive income.

The pension scheme asset should be included in the financial statements of Columbia Co at $25 million (the lower of $25 million and $47 million).

With a defined contribution scheme, it is the employee who undertakes all of the risk should the pension plan not perform to expectations. Columbia Co would have no obligations further to their contributions into the scheme. This means that provided the correct contributions have been paid into the scheme, no asset or liability would be recognised within their statement of financial position. The cash contributions of $0. 5 million are instead recognised as an expense in profit or loss.

2 Bismuth Co

Marking scheme

			Marks
(a)	Discussion and application of IAS 36 principles to scenario	3	
	Calculation of impairment	2	
			5
(b)	Discussion and application of IAS 32 principles to scenario	3	
	Contractual obligation discussion	2	
			5
(c)	Discussion of the following key ethical principles and application to the scenario:		
	– Confidentiality	3	
	– Competence	3	
	– Whistleblowing	2	
			8
	Professional marks		2
			20

(a) Most liabilities are ignored when calculating recoverable amounts in impairment testing. However, certain liabilities, such as decommissioning liabilities, cannot be separated from the related assets.

IAS 36 *Impairment of Assets* requires the carrying amount of a recognised liability to be deducted from both the carrying amount of a cash generating unit (CGU) and the amount determined using the value-in-use (VIU). The recoverable amount of the asset should be determined using the VIU model in IAS 36.

The amount of the decommissioning provision is used to calculate the net recoverable amount by deducting it from the VIU amount. The net recoverable amount is then compared to the carrying amount of the CGU which should be adjusted to include the decommissioning provision in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

Cash flow projections should be based on reasonable and supportable assumptions, the most recent budgets and forecasts, and extrapolation for periods beyond budgeted projections. IAS 36 presumes that budgets and forecasts should not go beyond five years; for periods after five years, extrapolation should be used from the earlier budgets. In this case, the mines have a useful life of five years or less and, therefore, the cash flow projections can be used in the impairment testing.

At 31 December 20X7	$ millions
Present value of future cash inflows from the sale of components for re-use	20
Present value of future cash inflows from sale of mining output	203
Present value of future cash outflows from operating the mines	(48)
Carrying amount of decommissioning provision	(53)
Recoverable amount (NPV of cash flows)	122
Carrying amount of mines	200
Carrying amount of decommissioning provision	(53)
Net carrying amount of mines	147

The recoverable amount is less than the carrying amount and, hence, there is an impairment charge of $25 million ($147 million – $122 million).

(b) IAS 32 *Financial Instruments: Presentation* states that a financial instrument is a financial liability if it provides that, on settlement, the entity will deliver either:

(i) cash or another financial asset; or

(ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Bismuth Co has discretion over whether 'rewards' are payable on class A shares and class B shares. The rewards are essentially a dividend paid on the investment. This would seem to indicate that both instruments should be classified as equity. The Bitcoin can be readily converted into cash in Bismuth Co's jurisdiction and therefore can be treated in the same way as legal tender or cash (also known as fiat money).

The possibility of Bismuth Co listing on a stock exchange is a contingent settlement provision. Bismuth Co is able to avoid listing shares on a stock exchange if it so chooses but is unlikely to do so, as the listing is deemed to be highly probable. Thus, the class A shares will be classified as a liability because the value of the share settlement of 1,000 class A instruments at 2 Bitcoin substantially exceeds that of the 'cash' settlement option of 1 Bitcoin for the same number of instruments and Bismuth Co is implicitly obliged to redeem the instruments for a 'cash' amount of 1 Bitcoin.

If Bismuth Co fails to exercise its call option on the class B shares, it must transfer an additional reward to the holder. An obligation must be established through the terms and conditions of the financial instrument. Anything outside the contractual terms is not relevant to the classification process in accordance with IAS 32. Therefore, the potential failure to exercise the call option does not affect the classification of class B shares as equity as there is no unavoidable contractual obligation to pay the reward or to call the instrument. Also, if the call option is not exercised, the reward payable will only constitute an increase in the dividend rate and not a redemption of the class B shares. Hence the class B shares constitute equity shares.

(c) Ms Pleasant is in a difficult position as regards information gained at a previous employer. In general, she should respect the confidentiality of information acquired as a result of professional and business relationships and therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose. In addition, she should not use the information for her personal advantage. However, the situation will depend upon the nature of the confidentiality agreement with her previous employer. This agreement may have been made in order to protect commercially sensitive information and to prevent her from sharing such information with Bismuth Co. However, if the agreement is not clear or specific, then it will be left up to the ethical conscience of Ms Pleasant as to whether she should disclose the information. The purpose of the agreement is to prevent the disclosure of this type of sensitive information and the chief accountant's ethical conscience should prevail. In addition, the confidentiality agreement may be legally binding.

Opportunities and challenges presented by technology, and new business models, require an evolving level of digital literacy by accountants. Accountants should provide relevant, decision-useful analysis to ensure that the right technological applications are adopted in the best interests of the business. New business models present opportunities for professional accountants to provide relevant advice on regulatory matters. This development requires a growing set of competencies. These competencies relate to not only financial matters but also social impact assessment, environmental accounting or other non-financial capital valuation techniques. Mr Fricklin is obviously not aware of the importance of the entity being environmentally aware as he has told the chief accountant not to worry about ethically sourced material data. Professional accountants need to expand their competency areas to include digital and social awareness. The fundamental principle of professional competence and due care requires that a professional accountant only undertake significant tasks for which the professional accountant has, or can obtain, sufficient specific training or experience. A professional accountant should not intentionally mislead an employer as to the level of expertise or experience possessed such as is the case with Mr Fricklin who has told the board that he has 'in depth knowledge' of the technology.

Ms Pleasant is in a difficult position as regards the competence and sabotage of the project by Mr Fricklin, as an act of 'whistleblowing' can cause a conflict of interest between the personal, organisational and societal spheres. This conflict stems from the way in which a whistle-blower is viewed. The chief accountant could be viewed as someone sharing knowledge of misconduct for the benefit of others or as someone who is acting 'disloyal' to their superior. Ms Pleasant will be torn between loyalty to Mr Fricklin and her own moral commitment.

As long as her motivations are sound and she is confident in the system and her knowledge, she should not hesitate to relay such information as she is helping to create an environmentally aware project which will enhance the company's business.

3 Sitka Co

Marking scheme

				Marks
(a)	(i)	Discussion and application of the following to the scenario:		
		IFRS 15	2	
		Updates of software	3	
		Single performance obligation	1	
		Revenue allocated over time	1	
		Cannot use residual value	1	
				8

			Marks
(ii)	Discussion and application of the following to the scenario:		
	IAS 38	2	
	IFRS 16	1	
	Service contract	1	
			4
(b)	Discussion and application of the following to the scenario:		
	IAS 27	2	
	IFRS 9	3	
	IAS 28	2	
	Calculation of profit or loss	1	
	Principles of OCI	1	
			9
(c)	Discussion and application of the following to the scenario:		
	IFRS 13 highest and best use	2	
	Grouping of fair values	2	
			4
			25

(a) (i) IFRS 15 *Revenue from Contracts with Customers* states that goods or services which are promised to a customer are distinct if both of the following criteria are met:

(a) the customer can benefit from the good or service either on its own or together with other resources; and

(b) the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

The updates are integral to Cent Co's ability to derive benefit from the licence during the four-year contract, because the entity works in an industry in which technologies change rapidly. The determination of whether licence and updates are separate performance obligations requires judgement. In this case, the updates improve the effectiveness of software without being essential However, for the updates to be combined with the licence, they should fundamentally change the functionality of the software or be essential to its functionality.

Although the software can function on its own without updates, the benefits of using the software would be significantly reduced. The frequency of the monthly updates indicates that they are essential to the effective operation of the software. However, Sitka Co should consider not only the frequency but also whether Cent Co accepts the updates. Updates are made available every month but Cent Co has only updated its software on two occasions which seems to indicate that the software is functional without updates.

To conclude, the benefit which Cent Co could obtain from the licence over the four-year term without the updates would be significantly reduced, the contract to grant the licence and to provide the expected updates is, in effect, a single promise to deliver a combined item to Cent Co. As Cent Co simultaneously receives and consumes the benefits of the entity's performance as it occurs, the performance obligation is satisfied over time. As the contract is a single promise, the revenue of $3 million will be allocated over the four-year time period. Sitka Co should disclose the method used to recognise revenue together with the judgements used to determine the timing of the satisfaction of performance obligations, in the financial statements for the year ended 31 December 20X7. It should not and cannot allocate $2.5 million to the monthly updates and the residual amount of $0.5 million to the licence of software as this does not faithfully reflect the stand-alone selling price of the software.

Note. If the conclusion was that the software could function without updates (since they are not essential to functionality, and Cent Co has only updated twice which could indicate the software is functional without updates), then two performance obligations would be identified and the contract price allocated to each performance obligation. This approach to an answer, if well argued, would have been given credit.

(ii) Cent Co pays fees to Sitka Co to access and use its software. The recognition criteria for an intangible asset in accordance with IAS 38 *Intangible Assets* are identifiability, control over a resource and existence of future economic benefits. These need to be considered when determining whether an intangible asset is created. The current arrangement with Sitka Co is likely to satisfy the identifiability and existence of future economic benefits criteria, but it is questionable whether the control criterion is satisfied. IAS 38 states that 'an entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits'. Cent Co does not own the rights to the software at any time.

Thus, Cent Co should not recognise an intangible asset because Cent Co does not control the resource.

The contract is not a lease contract in accordance with IFRS 16 *Leases* as Cent Co does not have the right to direct the use of an asset by having decision-making rights to change how and for what purpose the asset is used throughout the four-year contract. At 1 January 20X7, the contract gave Cent Co only the right to receive access to Sitka Co's software in the future and is therefore a service contract which is expensed over the four-year period.

(b) IAS 27 *Separate Financial Statements* requires an entity which prepares separate financial statements to account for investments in subsidiaries, joint ventures and associates either:

– at cost

– in accordance with IFRS 9 *Financial Instruments*

– using the equity method as described in IAS 28 *Investments in Associates and Joint Ventures*.

After the partial disposal, Marlett Co is not a subsidiary, joint venture or associate of Sitka Co but is an investment in an equity instrument. Therefore, IFRS 9 is used to account for the retained interest. Investments in equity instruments should be measured at fair value. However, IFRS 9 also states that an entity can make an irrevocable election at initial recognition to present subsequent changes in fair value in other comprehensive income. This can only occur if the investment is neither held for trading nor contingent consideration. In this case, Sitka Co could make such an election at 1 July 20X7. IAS 28 specifies how an entity should account for a transaction which results in discontinuing the use of the equity method because the investment ceases to be an associate or joint venture but retaining an interest which is a financial asset. Here the entity recognises in profit or loss any difference between:

(i) the fair value of the retained interest and any proceeds from disposing of a part interest in the associate or joint venture; and

(ii) the carrying amount of the investment at the date the equity method is discontinued.

Thus, Sitka Co would make a profit of $(10 + 3.5 – 12) million, i.e. $1.5 million. This applies regardless of whether the entity elects to present in OCI subsequent changes in fair value of the retained interest. Sitka Co should only present any difference in OCI to subsequent changes in fair value which arise after initial recognition. Such a difference is not a result of a change in fair value but instead results from a change in the measurement basis of the retained interest when an entity loses control of an investee. The difference also meets the definition of income or expenses in the *Conceptual Framework for Financial Reporting* (2018).

(c) IFRS 13 *Fair Value Measurement* states that the fair value of an asset is the price which would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. However, IFRS 13 also uses the concept of the highest and best use which is the use of a non-financial asset by market participants which would maximise the value of the asset or the group of assets and liabilities within which the asset would be used. The fair values of the two assets would be determined based on the use of the assets within the buyer group which operates in the industry. The fair value of the asset group of $230 million is higher than the asset group for the financial investor of $200 million. The use of the assets in the industry buyer group does not maximise the fair value of the assets individually but it maximises the fair value of the asset group. Thus, even though Qbooks would be worth $50 million to the financial investors, its fair value for financial reporting purposes is $30 million as this is the value placed upon Qbooks by the industry buyer group.

4 Colat Co

Marking scheme

				Marks
(a)	Discussion of:			
	Integration of sustainability issues		4	
				4
(b)	Discussion of impairment indicators		2	
	Conclusion		1	
				3
(c)	(i)	Discussion and application to scenario:		
		Derecognition of NCA	1	
		Change in accounting for decommissioning	3	
				4
	(ii)	Discussion and application to scenario of liability for environmental damage	2	
		Government grant	2	
				4
	(iii)	Discussion and application to scenario:		
		Hedged transaction	2	
		Accounting treatment	2	
				4
	(iv)	Discussion and application to scenario:		
		Contingent asset	2	
		Disclosure	2	
				4
	Professional marks			2
				25

(a) Sustainability has become an increasingly crucial aspect of investing. There is a growing recognition that sustainability can have a significant effect on company financial performance. Investors are increasingly integrating consideration of sustainability issues and metrics into their decision-making. Investors require a better understanding of the wider social and environmental context in which the business operates. This creates a greater trust and credibility with investors and a reduced risk of investors using inaccurate information to make decisions about the company.

Investors have shown an appetite for products which recognise and reflect the relationship between their investments and social and environmental conduct. Investors need to completely understand the nature of the companies in which they are looking to invest and need to incorporate material sustainability factors into investment decisions. They need to understand whether there are material risks or opportunities connected with sustainability factors which do not appear in traditional financial reports.

Their materiality will differ from sector to sector, industry to industry. Sustainability is often unique to the sector. This analysis can be the deciding factor between otherwise identical companies. If the company is viewed poorly based on its sustainability performance, it could lead to a non-investment decision. The increasing availability of data from companies offers the opportunity for rating and ranking analysis, as well as observing trends. These advances have led to the quantitative application of sustainability data in investment analysis and decision making. Companies need a greater knowledge of investor needs and perspectives to help make reporting more relevant to investors and to clearly communicate the financial value of the company's sustainability efforts.

(b) If Colat Co determines that the events resulting from a natural disaster have triggered impairment indicators, an impairment test must be performed in accordance with IAS 36 *Impairment of Assets* for the respective assets and/or cash-generating units. In this instance, a decline in customer demand has taken place because of the damage in reputation resulting from the disaster. Also, the share price of Colat Co has declined which again may indicate that the carrying amount of the entity's net assets is higher than its market capitalisation. Finally, damage to the manufacturing facility is a direct indicator and the increase in operating costs resulting from the replacement of a supplier in the region with an international supplier is an indirect indicator. The increase in costs as an indicator of impairment depends on the significance and duration of the expected change. Short-term, temporary disruptions are not necessarily indicative of an impairment for assets with a long-term remaining useful life. As a result of the above impairment indicators, an impairment test must be performed in accordance with IAS 36.

(c) (i) The destruction of a non-current asset (NCA) results in the derecognition of that asset as opposed to an impairment as there will be no future economic benefits expected either from its use or disposal. Therefore, the NCA of $250 million would be derecognised. As regards the decommissioning of the power plant, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires that a liability is recognised as soon as the obligation arises, which will normally be at commencement of operations. Similarly, IAS 16 *Property, Plant and Equipment* requires the initial cost of an item of property, plant and equipment to include an estimate of the amount of the costs to dismantle and remove the item and restore the site on which it is located. As regards the change in the useful life of the power plant, the present value of the decommissioning liability will increase because of the shorter period over which cash flows are discounted. This increase is added to the carrying amount of the asset, which is tested for impairment. The remaining carrying amount is depreciated prospectively over the following eight years.

(ii) Colat Co has, in the past, put right minor environmental damage which it has caused but it has never been involved in a natural disaster on this scale and there is no legal obligation. A constructive obligation for the environmental costs will only result in the recognition of a provision if there is an established pattern of past practice, published policies or a specific current statement that Colat Co will pay for the damage. In this case, the entity has not indicated to other parties that it will accept certain responsibilities and as a result, it has not created a valid expectation. IAS 37 states that a provision should be recognised only when there is a present obligation resulting from past events. The future expected costs would not meet the definition of a provision as there is no legal obligation nor a constructive obligation. In the case of the natural disaster, Colat Co is not at fault and therefore there will be no obligation to correct the environmental damage which may be put right by the government.

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* states that a government grant is recognised only when there is reasonable assurance that the entity will comply with any conditions attached to the grant and the grant will be received. A grant receivable as financial support should be recognised as income in the period in which it is receivable. In this case, Colat Co has only received acknowledgement of its application for a grant on 1 March 20X8 and, therefore, there is no reasonable assurance that the grant will be received. Further, it is not probable that the grant will be received and it should not be disclosed in the financial statements.

(iii) Prior to the disaster, Colat Co hedges commodity price risk in aluminium and such transactions constituted 'highly probable' hedged transactions in cash flow hedges under IFRS 9 *Financial Instruments*. However, the purchases which were considered highly probable prior to the natural disaster are now not expected to occur. Colat Co should follow hedge accounting principles up until the date of the natural disaster and then should cease hedge accounting. As the forecast transaction is no longer expected to occur, Colat Co should reclassify the accumulated gains or losses on the hedging instrument from other comprehensive income into profit or loss as a reclassification adjustment.

(iv) IAS 37 does not permit the recognition of contingent assets. Accordingly, an insurance recovery asset can only be recognised if it is determined that the entity has a valid insurance policy which includes cover for the incident and a claim will be settled by the insurer. The recognition of the insurance recovery will only be appropriate when its realisation is virtually certain, in which case the insurance recovery is no longer a contingent asset. Decisions about the recognition and measurement of losses are made independently of those relating to the recognition of any compensation which might be receivable. It is not appropriate to take potential proceeds into account when accounting for the losses. The potential receipt of compensation should be assessed continually to ensure that it is appropriately reflected in the financial statements. The asset and the related income are recognised in the period in which it is determined that a compensation will be received which means reviewing the situation after the end of the reporting period and before the date of approval of the financial statements.

In this case, as it appears probable that the insurance claim for the loss of the non-current assets would be paid and as this information was received before the financial statements were approved, the potential proceeds ($280 million) should be disclosed in the financial statements for the year ended 31 December 20X7. There would be no disclosure of the insurance recovery related to the relocation costs or the lost revenue as the recovery is not virtually certain. The insurance policy does not cover environmental damage which is the responsibility of the government.

ACCA

Strategic Business Reporting (International)

Mock Examination 4

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 Chuckle Co

Chuckle Co has an equity interest in a number of entities including Grin Co. Chuckie Co has recently acquired additional equity in Grin Co and the directors of Chuckie Co are unsure as to how this may impact upon their consolidated financial statements. The year end is 31 March each year.

The following **exhibits** provide information relevant to the question.

Exhibit 1 – Initial acquisition of Grin Co

On 1 April 20X2, Chuckle Co acquired 30% of the equity shares of Grin Co. The consideration consisted of $100 million cash. The carrying amount of the net assets of Grin Co on 1 April 20X2 were $286 million which was the same as their fair value. Since then, Grin Co has been correctly treated as an associate in the consolidated financial statements of Chuckle Co.

The remaining 70% of the equity of Grin Co at 1 April 20X2 is owned by a few other investors, none of which own more than 10% of the equity of Grin Co. Analysis shows that all shareholders have voted independently in the past. Chuckle Co and Grin Co share some key management personnel.

Exhibit 2 - Subsequent acquisition of Grin Co

Chuckle Co acquired a further 18% of Grin Co's equity on 1 April 20X6. The consideration for the further 18% of the equity shares of Grin Co on 1 April 20X6 was $66 million in cash. The fair value of the original 30% equity interest was $127 million at 1 April 20X6. The carrying amount of the net assets of Grin Co on 1 April 20X6 was $348 million which included some land which had been revalued upwards by $15 million and correctly accounted for on 1 April 20X5.

Deferred tax at 20% had also been correctly accounted for on this gain in the individual statement of financial position of Grin Co as at 31 March 20X6. The rest of the increase in the net assets of Grin Co since acquisition was solely due to profits. Grin Co paid no dividends during this period.

The remaining 52% of the equity of Grin Co at 1 April 20X6 is owned by a few other investors, none of which own more than 10% of the equity of Grin Co.

On 1 April 20X6, Chuckle Co also acquired some share options in Grin Co exercisable any time until 31 March 20X7. The exercise price of the options at 1 April 20X6 was just above the market price of Grin Co's shares. Grin Co has been profitable for a number of years and the share price has been on an upwards trend which is expected to continue. Chuckle Co would increase its ownership to 60% should it exercise its rights. It is believed that there would be additional cost savings should the additional shares be acquired as decisions at board level could be made more efficiently.

Exhibit 3 - Fair value of net assets of Grin Co

The carrying amounts of the net assets of Grin Co on 1 April 20X6 were as follows:

	$ millions
Non-current assets	355
Current assets	214
Deferred tax	(16)
Other liabilities	(205)
Total	348

Included within the non-current assets was the land which had been previously revalued upwards by $15 million (Exhibit 2) on 1 April 20X5. The carrying amount of this land at 1 April 20X5 and 20X6 was $50 million but its fair value was assessed to be $60 million at 1 April 20X6.

Current assets include finished goods with a cost of $84 million. The fair value of these goods is $131 million.

On 1 April 20X6, the directors of Chuckle Co also identified that Grin Co had an internally generated database of customers who were likely to be interested in purchasing their products. Although there were no contractual or legal rights associated with this database, a professional expert has estimated that competitors of Grin Co would be prepared to pay $5 million for this database. Grin Co has not recognised the database as an asset within their individual financial statements.

The current rate of tax is 20%. This rate should be applied to any fair value adjustments deemed necessary.

Chuckle Co has a policy of measuring the non-controlling interest as the proportionate share of the net assets.

Required

Draft an explanatory note to the directors of Chuckie Co to address the following issues:

(a) (i) why it was correct to initially classify Grin Co as an associate, as opposed to a subsidiary, on 1 April 20X2; **(4 marks)**

(ii) how Grin Co should be accounted for as an associate using equity method in the consolidated statement of financial position of Chuckie Co at 31 March 20X6. Your answer should also explain how the revaluation of the land at 1 April 20X5 was accounted for (exhibit 2) and include all relevant calculations; and **(5 marks)**

(iii) whether the classification of Chuckie Co's investment in Grin Co should change on 1 April 20X6. **(5 marks)**

(b) On the assumption that Chuckie Co obtains control on 1 April 20X6, explain:

(i) how the fair value of the non-current and current assets at acquisition (including any deferred tax adjustments) should be calculated; and **(8 marks)**

(ii) how goodwill/gain on bargain purchase should be calculated at 1 April 20X6. Your discussion should include a brief description of the accounting treatment arising from the additional purchase of the 18% equity in Grin Co. **(8 marks)**

(Total = 30 marks)

2 Agency Group

The Agency Group manufactures products for the medical industry. They have been suffering increased competition and therefore have sold a license to distribute an existing product and have also developed a new product which they hope will improve their market reputation. They have recently employed an ACCA student accountant. The year end is 31 December 20X7.

The following **exhibits** provide information relevant to the question.

Exhibit 1 – Ethical issues and foreign exchange

On 1 October 20X7, the finance director, Ms Malgun, a financial accountant, recruited Mr Raavi as an ACCA student accountant on a temporary employment contract which can be terminated by either party without reason. Mr Raavi has found it difficult to find employment and therefore accepted the risk attached to the employment contract. However, the jurisdiction has laws which protect employees from termination due to discrimination. Mr Raavi has been told by Ms Malgun that there has been a global slowdown in business and that the biggest uncertainty is customer demand. She has therefore impressed upon Mr Raavi that the company profitability targets are based upon achieving 30% higher net profit than their nearest competitors. Ms Malgun is partly remunerated through profit related pay.

Ms Malgun has been under significant pressure from the board of directors to meet performance targets and would normally prepare the year-end financial statements. However, for the current year end, she has delegated this task to Mr Raavi.

Mr Raavi has included in profit or loss the foreign exchange gains arising on the re-translation of a foreign subsidiary which is held for sale. Mr Raavi has emailed Ms Malgun informing her of the accounting treatment. Although Ms Malgun is an expert in IFRS® standards, she did not comment on this incorrect accounting treatment of the foreign exchange gains.

After the financial statements had been published, Ms Malgun disciplined Mr Raavi for the incorrect accounting treatment of the foreign exchange gains. However, despite this, she is prepared to make his employment contract permanent.

Exhibit 2 – Sale of licence

On 1 January 20X7, Agency Co granted (sold) Kokila Co a licence with no end date to sell a headache product (Headon) in South America. Agency Co has retained the rights to sell Headon in the rest of the world. The South American market's relative value compared to the rest of the world is 20%. The manufacturing process used to produce Headon is not specialised and several other entities could also manufacture it for Kokila Co. Kokila Co will purchase Headon directly from Agency Co at cost plus 50%. The product has been sold for many years.

On 1 January 20X7, Kokila Co made an up-front payment of $15 million and will make an additional payment of $3 million when South American sales exceed $35 million. Agency Co had correctly capitalised development costs for Headon as an intangible asset at a carrying amount of $30 million.

Exhibit 3 – Drug development

Agency Co is developing a biosimilar product for the treatment of a particular medical condition. A biosimilar product is one which is highly similar to another which has already been given regulatory approval. The existing approved product's (Xudix) patent is expiring and Agency Co has applied to the government for regulatory approval of its new product. The submission includes an analysis which compares Xudix to Agency Co's proposed product in order to demonstrate biosimilarity. The government has reviewed the analysis and allowed Agency Co to undertake initial medical trials. Agency Co feels that the trials are going well. The product is used in the treatment of a very specific condition which affects only a small group of people, and Agency Co has decided to develop this product for reputational reasons. A person using the product will only pay a notional amount for the product if it is proven to be effective.

Required

(a) (i) Discuss the appropriateness of Mr Raavi's accounting treatment of the foreign exchange gains on the re-translation of the foreign subsidiary which is held for sale. **(3 marks)**

(ii) Discuss any ethical issues raised by Ms Malgun's actions regarding her management of Mr Raavi. **(6 marks)**

(b) Discuss how the granting (sale) of the licence to Kokila Co should be accounted for by Agency Co on 1 January 20X7. **(5 marks)**

(c) Discuss the accounting treatment of the costs incurred to date in developing the biosimilar drug. **(4 marks)**

Professional marks will be awarded in part (a)(ii) for the quality of the discussion. **(2 marks)**

(Total = 20 marks)

Section B – BOTH questions are compulsory and MUST be attempted

3 Stem Co

Stem Co is a manufacturing company and is considering providing cars for its senior management. It has also entered into an agreement with two other companies to develop a new technology through a separate legal entity, Emphasis Co. The financial year end of Stem Co is 31 December 20X7.

The following **exhibits** provide information relevant to the question.

Exhibit 1 – Company cars

On 1 January 20X7, Stem Co is considering providing company cars for its senior management and is comparing three options.

Option 1

The cars can be leased for a period of four years starting on 1 January 20X7. The cars have a total market value of $75,274 on this date. The lease requires payments of $1,403 on a monthly basis for the duration of the lease term of which $235 is a servicing charge. Stem Co wishes to show the servicing charge as a separate line item in profit or loss.

At the end of the four-year period, there is no option to renew the lease or purchase the cars, and there is no residual value guarantee. The interest to be charged for the year ended 31 December 20X7 is correctly calculated at $2,274 based upon the implicit interest rate in the lease. The net present value of the lease payments over four years is $50,803 excluding the service charge.

Option 2

The cars can be purchased for $75,274 with a 100% bank loan. The cars would be purchased on 1 January 20X7 and held for four years. The estimated residual value is $29,753. Monthly service costs would still be $235 per month. The loan would be repayable in four annual instalments commencing 1 January 20X8. Assume that an average annual percentage rate on a loan is 5%.

Option 3

A final alternative is to lease the cars with a 12-month agreement on 1 January 20X7 with no purchase option. The cost would be $1,900 per month in advance including servicing charge. Stem Co would take advantage of the short-term lease exemption under IFRS 16 *Leases*.

Other relevant information

The profit before tax and before accounting for any of the three options for cars is likely to be $100,000 for the year ended 31 December 20X7. Stem Co depreciates cars over a four-year period using straight line depreciation.

Exhibit 2 - Emphasis Co

On 1 January 20X7, Stem Co has contributed cash to a new legal entity, Emphasis Co, and holds an interest of 40%. The other two companies contributing have retained equity interests of 40% and 20%, respectively. The purpose of the entity is to share risks and rewards in developing a new technology. The holders of a 40% interest can appoint three members each to a seven-member board of directors. All significant decisions require the unanimous consent of the board. The holder of the 20% interest can appoint only one board member and can only participate in the significant decisions of the entity through the board. There are no related parties.

Stem Co contributed cash of $150,000 to Emphasis Co. The entity will use the cash invested by Stem Co to gain access to new markets and to develop new products. At 1 January 20X7, the carrying amount of the net assets contributed by the three companies was $310,000 but the fair value of the net assets contributed was $470,000.

Required

(a) Explain, with suitable calculations, the impact of the three alternative company car options on:

- earnings before interest, tax, depreciation and amortisation (EBITDA);
- profit before tax; and
- the statement of financial position for the year ended 31 December 20X7.

Note: Candidates should refer to IFRS 16 *Leases* where appropriate. **(13 marks)**

(b) (i) Discuss briefly principles of the equity method of accounting and whether it is a more relevant measurement basis that cost or fair value for an investment in an associate company.

Note: There is no need to refer to any exhibit when answering part (b)(i). **(4 marks)**

(ii) Discuss why Stem Co's investment in Emphasis Co should be classified as a joint venture and how Stem Co should account for its interest at 1 January 20X7 in accordance with IAS 28 *Investments in Associates and Joint Ventures.*

Note: Candidates should show any relevant entries required in the accounting records of Stem Co. **(8 marks)**

(Total = 25 marks)

4 Symbal Co

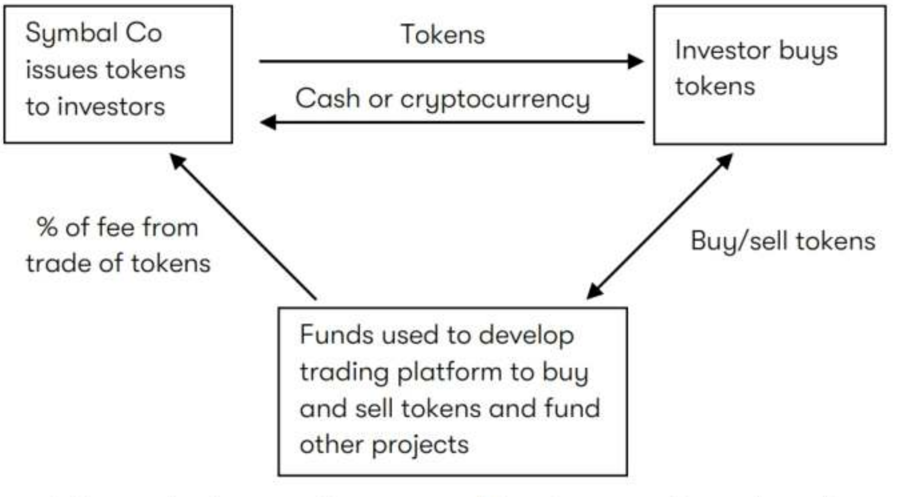
Symbal Co develops cryptocurrency funds and is a leading authority on crypto investing. Symbal Co specialises in Initial Coin Offerings ('ICO') that raises funds from investors in the form of cash or a crypto asset such as Bitcoin.

The year end of Symbal Co is 31 March 20X7.

The following **exhibits** provide information relevant to the question.

Exhibit 1– Development costs

The diagram below illustrates how the ICO is used by Symbal Co.



Note: The terms token and coin mean the same and investors are often referred to as supporters.

An ICO issues tokens to investors for cryptocurrency or cash. For each ICO, Symbal Co establishes a separate payment platform on which the investors can trade the tokens. These tokens do not represent an ownership interest in the entity. Symbal Co promises to produce gains for investors from trading the tokens on the platform and in return, the company takes a percentage of the profit as a fee.

As at 31 March 20X7, Symbal Co has incurred significant cost in promoting the issue of the ICO tokens, and developing the trading platform for dealing with the purchase and sale of the ICO tokens. These costs have been met from its own capital and expensed to profit or loss. Symbal Co will earn revenue from supporting the purchase and sale of tokens.

Exhibit 2 - ICO arrangements

Occasionally, Symbal Co enters into pre-sale agreements to raise funding from selected investors prior to a public sale of tokens. Symbal Co has entered into a pre-sale agreement with an investor which entitles the investor to a 10% discount on the price for tokens compared to other investors at the time of the ICO. On 1 March 20X7, the investor paid Symbal Co $1 million in cash. The issue date of the ICO is 30 April 20X7. The cash is only refundable if the ICO is abandoned before 30 April 20X7 because the minimum funding level of $9 million has not been achieved.

Once the tokens are issued, ICO investors can readily convert them into cash or cryptocurrencies on Symbal Co's platform but they do not entitle the holder to future goods and services from Symbal Co other than supporting the purchase and sale of tokens. The inflows received for tokens are used by Symbal Co to fund the future development of the payment platform and other projects.

In order to induce investment in the ICO, Symbal Co has made a commitment to the holders of tokens to pay a single payment of 10% of any annual profit for the year ended 31 March 20X8. The holders do not have any other rights such as redemption of their tokens or any residual interest in the assets of Symbal Co.

The ICO raised $10 million on 30 April 20X7.

Exhibit 3 – Tokens granted to directors

Symbal Co sometimes does not issue all the tokens from an ICO to investors but retains some to use to reward their employees. On 1 March 20X7, Symbal Co granted tokens to its five directors from the issue on 30 April 20X7. The award vests on 31 March 20X7 to directors who were in Symbal Co's employment at 31 March 20X7. The tokens give the directors the right to receive a car of their choice up to a value of $50,000 at any time in the next 12 months to 31 March 20X8 if they remain as directors of Symbal Co. All five directors were still with Symbal Co on 31 March 20X7.

Required

(a) Explain the principles of good disclosure which should be used to inform investors regarding the company's holding of crypto assets.

Note: there is no need to refer to any exhibit when answering part (a). **(6 marks)**

Professional marks will be awarded in part (a) for clarity and quality of discussion. **(2 marks)**

(b) Advise whether the various development and promotional costs related to the ICO can be accounted for as an intangible asset at 31 March 20X7. **(5 marks)**

(c) Discuss how the receipt of $1 million cash in the pre-sale agreement should be accounted for in the financial statements for the year ended 31 March 20X7 and how the $10 million raised in the ICO should be accounted for in the financial statements for the year ended 31 March 20X8. **(6 marks)**

(d) Discuss why the granting of the tokens to the five directors should be accounted for in accordance with IAS 19 *Employee Benefits* rather than IFRS 2 *Shared-based Payment* in the financial statements for the year ended 31 March 20X7. **(6 marks)**

(Total = 25 marks)

Answers

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

Section A

1 Chuckle Co

Marking scheme

				Marks
(a)	(i)	Discussion of control (IFRS 10 and other factors) v significant influence and application to the scenario		4
	(ii)	Discussion of equity accounting and application to the scenario	2	
		– Calculation of investment in associate	2	
		– Calculation of reserves	1	5
	(iii)	Application of the following discussion to the scenario:		
		– Acquisition of 18% equity	2	
		– Share options	3	5
(b)	(i)	Discussion and calculation of the following FV adjustments:		
		– Land and DT	2	
		– Inventory and DT	3	
		– Customer list	3	8
	(ii)	Application of the following discussion to the scenario:		
		– Piecemeal acquisition	3	
		– Gain on step acquisition calculation	1	
		– Impact on revaluation gain	1	
		– Goodwill calculation	3	8
				30

(a) (i) Significant influence is the ability to participate in the financial and operating policy decisions of the investee but is not control or joint control over these policies.

IFRS 10 *Consolidated Financial Statements* states that an investor controls an investee only if the investor has all of the following:

- power over the investee;
- exposure to or rights to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect the amount of the investor's returns.

Control is presumed to exist where the investor has a majority of the voting rights of the investee. This would usually give the investor the ability to direct the relevant activities, ie the activities which significantly affect the investee's returns. An ownership of 50% or less of the voting rights does not necessarily preclude an investor from obtaining control.

Prior to 1 April 20X6, Chuckle Co only owned 30% of the equity and no share options. Where an investor has a significant minority, close consideration should be given as to whether the voting rights alone or whether a combination of factors is deemed sufficient to obtain power. Chuckle Co and Grin Co do share some key management personnel which can sometimes be evidence of control. However, there has been no clear past voting pattern suggesting that Chuckle Co is unable to directly influence the economic decisions of the other investors. With only 30% of the equity and no additional potential rights, it would appear that Chuckle Co was only able to exercise significant influence rather than control. It can be concluded that it was correct to classify Grin Co as an associate.

(ii) Grin Co is an associate and would have been accounted for using the equity method in the consolidated financial statements of Chuckle Co. The initial investment is measured at cost and the carrying amount is increased to recognise the investors' share of the profits and other comprehensive income after the date of acquisition. One line would be included within non-current assets, investment in associate which at 31 March 20X6 would be valued at \$118.6 million (\$100m + (30% × (\$348m – \$286m))).

The revaluation gain of \$15 million would be recorded within other components of equity and deferred tax at 20% of \$3 million would be netted off within equity in the individual financial statements of Grin Co. In the consolidated financial statements Chuckle Co should include \$3.6 million (30% of the net gain of \$12 million (\$15m × 80%)) within other components of equity. As the remaining increase in net assets is due to profits (i.e. \$50 million (\$348m – \$286m – \$12m)), Chuckle Co should include \$15 million (30% × \$50m) within consolidated retained earnings.

(iii) The acquisition of the extra 18% of the equity on 1 April 20X6 would now unquestionably make Chuckle Co a significant minority investor. No other investor owns more than 10% of the equity so Chuckle Co owns a much higher proportional share (48%). Where the other shareholdings are owned by a large number of unconnected, dispersed holders, it would be clear that power has been obtained. However, the other shares are owned by just a few other investors which is unlikely to be considered a large, dispersed group of unconnected shareholders.

Potential voting rights should be considered in the assessment of control. For these to be included in the assessment, the rights should be substantive. That would usually mean that they are currently exercisable and have an exercise price which is below the market price of the shares so that they are 'in the money'. In that sense it is worthwhile for the investor to acquire the extra shares. In the case of Chuckle Co, they own share options that are currently exercisable but not in the money. This is because the exercise price is above the share price of Grin Co. However, it can be seen that they are only just out of the money. In addition, the share price of Grin Co is expected to increase and cost savings are expected from a further acquisition of shares. It seems therefore that the share options would be deemed to be substantive. Since exercising these options would enable Chuckle Co to obtain a 60% shareholding, it can be concluded that Chuckle Co is able to exercise power over Grin Co from 1 April 20X6. Grin Co should be reclassified from an associate to a subsidiary at this date.

(b) (i) It is necessary for the calculation of goodwill that Chuckle Co measures the identifiable assets acquired and the liabilities assumed at their acquisition date fair values. IFRS 13 *Fair value Measurement* should be considered in the assessment of the fair values. It has been identified that the fair value of the land is \$10 million above carrying amount. The valuation should be representative of the amount which market participants would be willing to sell the asset or transfer the liability in an orderly transaction under current market conditions.

The increase in value of \$10 million will create an additional taxable temporary difference. In effect, the carrying amount of the land is increased by \$10 million with no alteration to the tax base. An additional deferred tax liability arises at the acquisition date of \$2 million. Since the deferred tax is an identifiable liability at the acquisition, it should be recognised on acquisition with a corresponding increase in net assets of \$8 million (\$10m – \$2m).

Finished goods should be valued at their estimated sales price less the sum of the costs of disposal and a reasonable profit allowance for the selling effort of the acquiring entity. The fair value of the finished goods is \$131 million and so a fair value adjustment of \$47 million (\$131m – \$84m) is required. This creates a further taxable temporary difference in the consolidated financial statements of Chuckle Co with a corresponding deferred tax liability at 20% of \$9.4 million.

It is correct that the database as an internally generated intangible asset is not recognised in the individual financial statements of Grin Co. On acquisition, Chuckle Co should recognise the database as a separate intangible asset from goodwill in the consolidated financial statements providing that the database satisfies the criteria for recognition as an intangible asset and a reliable estimate of the fair value can be determined. Although there are no contractual or legal rights associated with the database, the database still appears to be identifiable as it could be sold separately to Grin Co's competitors. The professional expert's valuation of $5 million would appear to provide a reliable estimate of fair value. The database should therefore be recognised in the consolidated financial statements at $5 million with a further increase to the deferred tax liability at 20% equal to $1 million.

(ii) The additional purchase of the 18% equity would constitute a piecemeal or step acquisition. Goodwill will be calculated as the amount by which the fair value of the consideration exceeds the fair value of the identifiable net assets on acquisition. Chuckle Co must therefore remeasure its previously held equity interest in Grin Co at its acquisition fair value and recognise the resulting gain or loss in profit or loss. The previously held equity interest would have a carrying amount of $118.6 million (part (b)). The fair value is $127 million, so a gain of $8.4 million is recognised in the consolidated statement of profit or loss. Goodwill will be calculated including both the fair value of the original consideration and the fair value of the additional consideration.

The previous revaluation gain (net of deferred tax) which was included within other comprehensive income should be recognised on the same basis as would be required if Chuckle Co had disposed directly of the previously held equity interest. Since gains on revaluation are not reclassified to profit or loss on disposal, $3.6 million (see part (a) (ii)) should be transferred from the revaluation surplus of the group to retained earnings on 1 April 20X6.

Goodwill will be calculated as follows:

	$m	$m
Consideration of 18% holding		66.0
Fair value of original 30% holding		127.0
Non-controlling interest at acquisition (397.6 × 52%)		206.8
Less net assets at acquisition:		
Net assets per question	348.0	
Fair value adjustment land	10.0	
Subsequent deferred tax	(2.0)	
Fair value adjustment inventory	47.0	
Subsequent deferred tax	(9.4)	
Database	5.0	
Subsequent deferred tax	(1.0)	
		(397.6)
Goodwill on acquisition of Grin Co		2.2

2 Agency Co

Marking scheme

				Marks
(a)	(i)	Discussion of appropriateness of the accounting policy		3
	(ii)	Application and discussion of ethical principles to scenario which includes: Employment contract Accounting policy and profit related pay Time pressures Competition Less severe discipline		6
(b)		Discussion of key principles of IFRS 15 and relate to scenario	2	
		Derecognition of intangible asset and IAS 38	2	
		Calculation of gain	1	5
(c)		Setting out principles for capitalisation	1	
		Application of principles to scenario	3	4
		Professional marks		2
				20

(a) (i) IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires gains and losses to be reclassified from equity to the statement of profit or loss (SOPL) as a reclassification adjustment. When a group has a foreign subsidiary, a group exchange difference will arise on the re-translation of the subsidiary's goodwill and net assets. In accordance with IAS 21, such exchange differences are recognised in other comprehensive income (OCI) and so accumulate in other components of equity (OCE). On the disposal of the subsidiary, IAS 21 requires that the net cumulative balance of group exchange differences be reclassified from equity to the SOPL as a reclassification adjustment. Mr Raavi should not have included the exchange gains arising on the re-translation of the foreign subsidiary in the SOPL as it is currently only held for sale. When the subsidiary is then sold, the gains accumulated in OCE may be reclassified to profit or loss.

(ii) Although Mr Raavi is a student accountant, he is bound by the same ethical codes as a qualified accountant. Mr Raavi is employed on the basis that either he or Agency Co can choose to terminate his employment for no reason. Even though the jurisdiction has laws which protect such employees from termination due to discrimination, it can be argued that the ability to terminate employment benefits the employer more than the employee. Thus, a primary issue is whether this type of employment contract is fair to the employee and whether it can result in unethical behaviour.

It can be argued that fear of termination acts as a motivation for Mr Raavi to act unethically and that this type of employment has provided Mr Raavi with an opportunity as he had struggled to be employed. It is arguable whether fear of losing his job is an effective motivator for Mr Raavi. Also, allowing employees to be arbitrarily dismissed amounts to treating them with very little respect. The employer's ability to terminate a contract without reason undermines Mr Raavi's potential to set and achieve goals for himself. Mr Raavi's ability to terminate employment without cause, on the other hand, has comparatively little effect on the company's ability to set and achieve its goals.

Competitive markets are more likely to see unethical behaviour especially if unethical behaviour benefits the organisation. Accountability can have a major influence on ethical behaviour. People may behave unethically if they do not have responsibility for their actions. Mr Raavi is only an ACCA student accountant and therefore would not bear the ultimate responsibility for the inaccurate accounting for foreign exchange gains. Ms Malgun obviously knew that the accounting was inaccurate but because it benefited the company and helped the performance targets, she was prepared to overlook it. Also, this can be an unintended consequence of performance related pay as Ms Malgun is partly remunerated through profit related pay. However, in order to preserve her position, she disciplined Mr Raavi after the financial statements had been published, thus displaying a lack of integrity and professional values in her dealings with Mr Raavi and stakeholders.

Ms Malgun should not have left the preparation of the year-end financial statements to Mr Raavi as he is a student accountant and has only been with the company for 3 months. She has significant experience and expertise in their preparation. Work pressure can influence ethical behaviour. Difficult performance goals and time pressure make unethical behaviour more likely. When employees are under pressure, this not only affects their wellbeing and motivation, but also their behaviour. Ms Malgun is an expert in IFRS standards and should have ensured that she allocated some time to assist Mr Raavi in the preparation of the year-end financial statements. It is the responsibility of both Ms Malgun and Mr Raavi to engage in fair and accurate reporting with regard to the truthfulness of the data they provide as well as its completeness. It is ethically important for accountants to present the financial information in a way which is clear and honest.

Competition can influence unethical behaviour. Individuals are more inclined to engage in unethical behaviour when their organisation is in competition with other organisations or they have been given targets which have to be met. When unethical behaviour leads to a gain for a company, managers choose less severe disciplinary measures for their employees. Thus, although Ms Malgun knew of the error in the financial statements, she only reprimanded Mr Raavi after the financial statements had been published and even then, she then offered him a full-time contract instead of his current temporary contract.

(b) Agency Co had correctly capitalised development costs for Headon at a carrying amount of $30 million. IAS 38 *Intangible Assets* states that an intangible asset, in this case a proportion of the development costs, may be derecognised on disposal or when no future economic benefits are expected from its use or disposal. The gain or loss arising on derecognition is the difference between the net proceeds and the carrying amount of the asset. Gains are not classified as revenue. The amount of gain or loss arising from the derecognition will be affected by the determination of the transaction price with reference to IFRS 15 *Revenue from Contracts with Customers*.

In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable, the objective of IFRS 15 is to determine whether the nature of the promise is to transfer each of those goods or services individually or, instead, to transfer a combined item.

Kokila Co can benefit from the licence without Agency Co's manufacturing service because there are other entities which can provide the manufacturing service. Therefore, Agency Co's promises to grant the licence and to provide the manufacturing service are separately identifiable.

The consideration for the licence comprises the up-front payment of $15 million and a variable consideration of $3 million. Initially, only the up-front payment will be recognised as proceeds together with the gain on the disposal of the South American development costs. The variable consideration will be recognised in SOPL when it occurs, i.e. when South American sales exceed $35 million. The performance obligation needs to be satisfied before the payment is recognised.

Judgement is required to determine the portion of the carrying amount of the intangible asset to derecognise, relative to the amount retained. Therefore, a gain is recognised on disposal of the South American development costs of $9 million ($15m – ($30m × 20%)).

(c) Development costs are capitalised as an intangible asset if certain criteria in IAS 38 are met. There is no definitive starting point for the capitalisation of internal development costs and, therefore, Agency Co must use its judgement, based on the facts and circumstances of each product. A strong indication that Agency Co has met all of the IAS 38 criteria arises when regulatory approval is issued for the biosimilar drug as it proves the technical feasibility of the asset. This is often the most difficult criterion to demonstrate.

Another criterion to be met is that the asset should generate probable future economic benefits and demonstrate the existence of a market, or the usefulness of the asset if it is to be used internally. At present, this criteria has not been met as the product is aimed at a small group of people who will only pay a notional amount if it is an effective product.

In addition, regulatory approval has only been applied for, and there is a concern over the limited market and revenue stream. Thus, the costs are unlikely to meet the capitalisation criteria and all costs to date will be written off to profit or loss.

3 Stem Co

Marking scheme

				Marks
(a)	Discussion and application of principles to scenario:			
	IFRS 16 *Leases*		3	
	Purchasing cars		2	
	12-month leases		2	
	Impact on EBITDA and profit		3	
	SOFP		3	13
(b)	(i)	Discussion of key principles of equity accounting:		
		Nature	2	
		Cost	1	
		Fair value	1	4
	(ii)	Discussion of key principles of joint venture accounting including a well argued conclusion	5	
		Discussion of bargain purchase	2	
		Accounting for bargain purchase	1	8
				25

(a) **Option 1 Leased for a four-year period**

At 1 January 20X7, a right-of-use asset and lease liability of $50,803 would be recognised according to IFRS 16 *Leases*. The annual lease component of the lease payments is $14,016 (12 × $1,403 - $235) and the service component is $2,820 (12 × $235). At 31 December 20X7, operating expenses will comprise the service component of $2,820, and depreciation of $12,701 ($50,803/4). An interest expense of $2,274 will be recognised as a finance cost. The lease liability recognised will be $50,803 less the annual payments of $14,016 plus the interest element of $2,274 ie $39,061. The closing lease liability will be split between its non-current and current liability in the statement of financial position. IFRS 16 requires a company to recognise interest on lease liabilities separately from depreciation of lease assets.

Option 2 Purchased on 1 January 20X7

If the cars were purchased on 1 January 20X7, then depreciation would be charged of $11,380 ($75,274 - $29,753 = $45,521/4 = $11,380) and interest of $3,763 ($75,274 x 5%) would also be charged. The cars would have to be serviced at a cost of $2,820.

Option 3 Leased on a 12-month agreement

Instead of applying the recognition requirements of IFRS 16, a lessee may elect to account for lease payments as an expense on a straight-line basis over the lease term for the following two types of leases:

(i) leases with a lease term of 12 months or less and containing no purchase options; and

(ii) leases where the underlying asset has a low value.

The effect of applying the IFRS 16 exemption would be that neither an asset nor a liability will be recognised and therefore it will not affect the statement of financial position. Neither a right of use asset nor lease liability will be recognised if this exemption is applied. Instead, an expense will be recognised in the statement of profit or loss.

The cost of the short-term lease would be included in operating expenses at $22,800 (12 × $1,900).

It can be seen that the impact on EBITDA is greatest if 12-month leases are chosen. This is because the cost is shown in operating expenses. Additionally, profit before tax is lower under this option. EBITDA does not include lease interest when IFRS 16 is used and thus is naturally higher.

There will be no effect on EBITDA if Kayte Co leases or buys the cars and, further, the impact on profit before tax is minimal with profit being lower if Kayte Co purchases the cars.

If 12-month leases are chosen, then there will be no recognition of an asset for the cars which will result in a higher asset base for the four-year lease/purchase of cars, which will affect ratios such as asset turnover. Similarly, a liability will not be recognised in the case of the 12-month lease which will mean higher financial liabilities for the four-year lease/purchase, which will affect financial leverage (gearing).

The carrying amount of the leased cars will typically reduce more quickly than the carrying amount of lease liabilities. This is because, in each period of the lease, the leased car is depreciated on a straight-line basis, and the lease liability is reduced by the amount of lease payments made and increased by the interest which reduces over the life of the lease. Consequently, although the amounts of the lease asset and lease liability are the same at the start and end of the lease, the amount of the asset would typically be lower than that of the liability throughout the lease term. This will result in a further reduction in reported equity as compared to 12-month leases. This will be similar to the effect on reported equity which arises from financing the purchase of the cars through a loan.

	Lease over 4 years	*Purchase with loan*	*12-month leases*
	($)	($)	($)
Profit before accounting for cars	100,000	100,000	100,000
Service cost	(2,820)	(2,820)	
Operating expense			(22,800)
EBITDA	97,180	97,180	77,200
Depreciation	(12,701)	(11,380)	
Interest	(2,274)	(3,763)	
Profit before tax	82,205	82,037	77,200
PPE	38,102	63,894	0
	(50,803-12,701)	(75,274-11,380)	
Lease/Loan Liability	39,061	79,039	0
		(75,274+3,763)	

(b) (i) The equity method is a measurement method and not a consolidation method, as the equity-accounted entity remains as a single line in the investor's statement of financial position and IFRS Standards consolidation is based on the existence of control. Equity accounting is a measurement method for investments where there is 'significant influence' and recognises an associate's profits which have not been received and could not be successfully demanded. The equity method provides better information than that provided by cost, but it can be argued that where investments are listed, then there is no reason not to use fair value. The equity method is likely to be better than cost because cost is in isolation an uninformative basis for decision-making. However, if an investment is listed, then its fair value would be easier to establish and more intuitively appealing than the numbers derived from the equity method. If the associate is unlisted, then there might be questions about the verifiability of fair value. However, even then, there appears to be no reason why the equity method should be preferred to IFRS 13 *Fair Value Measurement*.

(ii) The following are the characteristics of a joint venture:

- Joint ventures are joint arrangements which are structured through a separate vehicle which confers legal separation between the joint venture and the assets and liabilities in the vehicle.
- The entity must be under the joint control of the venturers, which is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
- The venturers must be able to exercise joint control of the entity.
- The purpose of the entity must be consistent with the definition of a joint venture.

Emphasis Co is a joint venture. Its activities are conducted through a separate legal entity and the parties participating in the decision making, exercise control through their equity investments. This control is determined by the ability to appoint board members. This means that the significant decisions require the unanimous consent of all of the parties. The company holding 20% of the equity can only appoint one board member but does have the ability to prevent the remaining companies from making significant decisions without its consent.

Each party to the joint venture (or each 'joint venturer') recognises an investment, which is accounted for using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures*.

According to IAS 28, where an investor's investment is less than their share of the fair value of the identifiable net assets acquired, this results in a gain to the investor and is referred to as a bargain purchase. IAS 28 states that on the acquisition of the investment in an entity, any difference (whether positive or negative) between the cost of acquisition and the investor's share of the fair values of the net identifiable assets of the entity is accounted for like goodwill in accordance with IFRS 3 *Business Combinations*. Thus, any excess fair value of the identifiable net assets over the cost of the equity method investment would be recognised as a bargain purchase gain in earnings on the investment date, which is consistent with the accounting for bargain purchases in business combinations.

However, bargain purchases are rare. Therefore, before recognising a gain on a bargain purchase, Stem Co should reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed as part of the investment, in order to ensure that all identifiable assets or liabilities are properly recognised. In addition, Stem Co should reconsider and challenge all valuations to verify that the identifiable net assets are properly measured. Stem Co should try to understand why the other parties would contribute assets of higher value than those contributed by Stem Co. Usually, investors act in an economically rational manner. There may be strategic reasons for such actions. For example, Stem Co may have specialised knowledge of the industry. Also, the fair value of the net identifiable assets of the Emphasis Co may have increased before the finalisation of the agreement.

Stem Co contributed cash of $150,000 to Emphasis Co. The carrying amount of the net assets contributed by the investors was $310,000 but the fair value of the net assets contributed was $470,000 .Therefore, Stem Co's share of the fair value of the identifiable assets of Emphasis Co is 40% of $470,000, ie $188,000 .This exceeds the contribution of $150,000.Once Stem Co has reassessed whether it has correctly identified all of the assets acquired and all of the liabilities assumed as part of its investment in Emphasis Co, Stem Co will record the investment at $188,000 and will record a gain of $38,000 ($188-$150)000.

Dr	Investment in Emphasis Co	$188,000	
Cr	Cash		$150,000
Cr	Profit or loss		$38,000

4 Symbal Co

Marking scheme

			Marks
(a)	Discussion of key principles of disclosure for crypto assets		6
(b)	Discussion of:		
	Principles of IAS 38	2	
	Application to scenario	3	5
(c)	Application of the following discussion to the scenario of:		
	Pre-sale agreement/IAS 32	3	
	ICO and profit entitlement	3	6
(d)	Discussion of key principles of the award – IAS 19/IFRS 2	3	
	Accounting for the award	3	6
	Professional marks		2
			25

(a) There is significant interest in crypto assets with implications for both new and traditional investors. There is a growing need for clarity regarding the accounting and related disclosures relating to these new investments. The general disclosure principles which should be used to help investors can include that the disclosures should be entity-specific as information tailored to an entity's own circumstances is more useful than generic information which is readily available outside the financial statements. Thus, detailed information concerning the company's holding of crypto assets and Initial Coin Offerings (ICO) should be disclosed. The company's involvement in ICO's or other issues of crypto assets should be described as simply and directly as possible without a loss of material information and without unnecessarily increasing the length of the financial statements. Additionally, the information disclosed should be organised in a way which highlights important matters which includes providing disclosures in an appropriate order and emphasising the important matters within them. It is important that the terms of an ICO are disclosed so that investors can determine the rights associated with it.

The information about crypto assets should be linked when relevant to other information in the financial statements or to other parts of the annual report to highlight relationships between pieces of information and improve navigation through the financial statements. Commodity broker-traders holding crypto-assets as inventory at fair value less costs to sell, in addition to the general IAS 2 *Inventories* requirements, will need to disclose the carrying amount of such inventories carried at fair value less costs to sell. In addition, IFRS 13 *Fair value measurement* disclosure requirements for recurring fair value measurements would also apply. The information about crypto assets should be provided in a way which optimises comparability among entities and across reporting periods without compromising the usefulness of the information. Holders of crypto assets classified as intangible assets under IAS 38 *Intangible Assets* will need to disclose, by class, a reconciliation between the opening and closing carrying amounts, whether the useful life is assessed as indefinite, and, if so, the reasons supporting the indefinite useful life assessment, and a description of individually material holding.

Finally, the proper application of materiality is key to determining what information to disclose. The judgmental nature of materiality assessments could lead to entities omitting useful information concerning crypto assets from the financial statements. Similarly, difficulties in exercising judgement around materiality could contribute to 'disclosure overload'.

(b) If the costs do not satisfy the requirements of IAS 38 they are recognised as expenses. The costs satisfy the requirements for recognition of intangible assets 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. The probability of future economic benefits must be based on reasonable and supportable assumptions about conditions which will exist over the life of the asset.

In making the decision on recognition of the costs incurred, Symbal Co should evaluate whether after the issue of the tokens, it is still capable of controlling the trading platform and whether it may reasonably expect future economic benefits from the token holders. It is important to know whether Symbal Co will be able to get future economic benefits from token holders by providing them with future services other than another issue of tokens.

If costs incurred will not ensure further economic benefits, they should be immediately recognised as an expense in profit or loss. In this case, Symbal Co promises to produce gains for investors from trading the tokens on the platform and in return, the company takes a percentage of the profit as a fee. Thus, the company can reasonably expect further economic benefits after the issue of tokens. The costs may be recognised as an intangible asset and amortised over the useful life of these assets. However, IAS 38 states that an entity should expense promotional activity costs when incurred. Thus, these costs should be excluded from the intangible asset.

If during future reporting periods new circumstances are revealed, which indicate that there may be no more future economic benefits, then the value of the intangible asset would be impaired and written down.

(c) **Year ended 31 March 20X7**

The success of the ICO is not within the control of Symbal Co as the ICO can be abandoned if the minimum fundraising level of $9 million is not reached. Neither does the investor have the right to be repaid $1 million in cash prior to 30 April 20X7. However, on the basis that the occurrence of a successful ICO is beyond the control of the entity, the agreement contains a financial obligation, because it represents a contractual obligation to deliver cash or another financial asset to another entity if the ICO does not occur by 30 April 20X7. At 31 March 20X7, the $1 million is viewed as a financial liability of Symbal Co in accordance with IAS 32 *Financial Instruments: Presentation* at initial recognition.

Year ended 31 March 20X8

At 30 April 20X7, the funds paid by the holders of tokens of $10 million have the one-off right to 10% of profits from the year ended 31 March 20X8 but they do not have the right to their redemption or residual interest in the assets. Due to this reason, the company should not record any inflows as a financial liability or equity but record them as income by the following accounting entry.

Dr	Bank	$10 million	
Cr	Other financial income		$10 million

Also at 30 April 20X7, the liability of $1 million recorded for the pre-sale agreement will be reversed and recorded as income.

Initially, at 30 April 20X7, the commitment to the holders of tokens to pay 10% of annual profits for the year ended 31 March 20X8 is considered by Symbal Co to be a contingent liability. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* defines a contingent liability as a possible obligation depending on whether some uncertain future event occurs. The recognition of the liability depends on whether there are annual profits. Therefore, a liability should be recognised if the company earns profits during the reporting period to 31 March 20X8. Symbal Co will recognise a financial liability to the holders of tokens and an expense to profit or loss.

The tokens are not equity instruments as they do not have a residual interest in the assets of the entity after deducting all of its liabilities and they have a contractual obligation to deliver cash.

(d) When assessing the accounting treatment of such arrangements, an entity should consider the characteristics of the ICO tokens generated. Equity is the residual interest in the assets of an entity after deducting all of its liabilities. Unless the ICO tokens meet the definition of equity, the arrangements would not meet the definition of a share-based payment arrangement in accordance with IFRS 2 *Share-based Payment*. Instead, they would fall within the scope of IAS 19 *Employee Benefits* as a non-cash employee benefit. IAS 19 can then be used to determine the recognition, as well as the measurement, of the employee benefit.

The tokens do not meet the definition of the equity of Symbal Co as they do not grant the directors a residual interest in the net assets of the Symbal Co. Therefore, the arrangements do not meet the definition of a share-based payment arrangement in accordance with IFRS 2. Instead, it is a non-cash short term employee benefit. Short-term employee benefits are those expected to be settled wholly before twelve months after the end of the annual reporting period during which employee services are rendered. The substance of the arrangement is an exchange of employee services for the tokens.

The arrangement includes a condition that the directors should be in employment at 31 March 20X7. Symbal Co should recognise a liability and short-term employee benefit expense at 31 March 20X7.

Symbal Co would measure the amount that it expects to pay by using the fair value of the tokens to be delivered to the employees, or by using the estimated cost of the goods or services which it expects to deliver in the future. This amount would be (5 x $50,000) $250,000.

Thus, at 31 March 20X7

Dr	Employee costs	$250,000	
Cr	Short-term employee benefit liability		$250,000

Mathematical Tables

Present value table

Present value of 1 = $(1+r)^{-n}$ where r = discount rate, n = number of periods until payment.

This table shows the present value of £1 per annum, receivable or payable at the end of *n* years.

Periods (n)	Discount rates (r) 1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

Periods (n)	Discount rates (r) 11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.074	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026

Cumulative present value table

This table shows the present value of £1 per annum, receivable or payable at the end of each year for *n* years.

Periods (n)	Discount rates (r) 1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.37	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.26	10.58	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.13	11.35	10.63	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.00	12.11	11.30	10.56	9.899	9.295	8.745	8.244	7.786	7.367
15	13.87	12.85	11.94	11.12	10.38	9.712	9.108	8.559	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.678	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.351	14.877	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Periods (n)	Discount rates (r) 11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	4.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

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