- The directors of Fill require advice on how to treat the reconditioning costs and whether the decline in the price of coal is an impairment indicator. (8 marks)
- (c) Fill jointly controls coal mines with other entities. The Theta mine was purchased by three participants during the year. Fill owns 40%, and the other two participants own 35% and 25% of the mine. The operating agreement requires any major decisions to be approved by parties representing 72% of the interest in the mine.

The directors of Fill wish advice on whether the Conceptual Framework will affect the decision as to whether Fill controls the mine.

The directors are also wondering whether the acquisition of the 40% interest would be considered a business combination under IFRS Standards. (10 marks)

Required:

Advise the directors of Fill on how the above transactions should be dealt with in its financial statements with reference to relevant IFRS Standards and the Conceptual Framework.

Note: The split of the mark allocation is shown against each of the three issues above.

(Total: 25 marks)

46



HOLLS (DEC 2018) Walk in the footsteps of a top tutor



Answer debrief

(a) The IFRS Practice Statement Management Commentary provides a broad, non-binding framework for the presentation of management commentary which relates to financial statements which have been prepared in accordance with IFRS Standards. The management commentary is within the scope of the Conceptual Framework and, therefore, the qualitative characteristics will be applied to both the financial statements and the management commentary.

Required:

- (i) Discuss briefly the arguments for and against issuing the IFRS Practice Statement Management Commentary as a non-binding framework or as an IFRS Standard. (4 marks)
- (ii) Discuss how the qualitative characteristics of understandability, relevance and comparability should be applied to the preparation of the management (5 marks) commentary.
- Holls Group is preparing its financial statements for the year ended 30 November 20X7. (b) The directors of Holls have been asked by an investor to explain the accounting for taxation in the financial statements.

The Group operates in several tax jurisdictions and is subject to annual tax audits which can result in amendments to the amount of tax to be paid.

The profit from continuing operations was \$300 million in the year to 30 November 20X7 and the reported tax charge was \$87 million. The investor was confused as to why the tax charge was not the tax rate multiplied by the profit from continuing operations. The directors have prepared a reconciliation of the notional tax charge on profits as compared with the actual tax charge for the period.

	\$ million
Profit from continuing operations before taxation	300
Notional charge at local corporation tax rate of 22%	66
Differences in overseas tax rates	10
Tax relating to non-taxable gains on disposals of businesses	(12)
Tax relating to the impairment of brands	9
Other tax adjustments	14
Tax charge for the year	87

The amount of income taxes paid as shown in the statement of cash flows is \$95 million but there is no current explanation of the tax effects of the above items in the financial statements.

The tax rate applicable to Holls for the year ended 30 November 20X7 is 22%. There is a proposal in the local tax legislation that a new tax rate of 25% will apply from 1 January 20X8. In the country where Holls is domiciled, tax laws and rate changes are enacted when the government approves the legislation. The government approved the legislation on 12 November 20X7. The current weighted average tax rate for the Group is 27%. Holls does not currently disclose its opinion of how the tax rate may alter in the future but the government is likely to change with the result that a new government will almost certainly increase the corporate tax rate.

At 30 November 20X7, Holls has deductible temporary differences of \$4.5 million which are expected to reverse in the next year. In addition, Holls also has taxable temporary differences of \$5 million which relate to the same taxable company and the tax authority. Holls expects \$3 million of those taxable temporary differences to reverse in 20X8 and the remaining \$2 million to reverse in 20X9. Prior to the current year, Holls had made significant losses.

Required:

With reference to the above information, explain to the investor, the nature of accounting for taxation in financial statements.

Note: Your answer should explain the tax reconciliation, discuss the implications of current and future tax rates, and provide an explanation of accounting for deferred taxation in accordance with relevant IFRS Standards. (14 marks)

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

(2 marks)

(Total: 25 marks)



Calculate your allowed time, allocate the time to the separate parts......

47



SKIZER (SEP 2018) Walk in the footsteps of a top tutor

(a) Skizer is a pharmaceutical company which develops new products with other pharmaceutical companies that have the appropriate production facilities.

Stakes in development projects

When Skizer acquires a stake in a development project, it makes an initial payment to the other pharmaceutical company. It then makes a series of further stage payments until the product development is complete and it has been approved by the authorities. In the financial statements for the year ended 31 August 20X7, Skizer has treated the different stakes in the development projects as separate intangible assets because of the anticipated future economic benefits related to Skizer's ownership of the product rights. However, in the year to 31 August 20X8, the directors of Skizer decided that all such intangible assets were to be expensed as research and development costs as they were unsure as to whether the payments should have been initially recognised as intangible assets. This write off was to be treated as a change in an accounting estimate.

Sale of development project

On 1 September 20X6, Skizer acquired a development project as part of a business combination and correctly recognised the project as an intangible asset. However, in the financial statements to 31 August 20X7, Skizer recognised an impairment loss for the full amount of the intangible asset because of the uncertainties surrounding the completion of the project. During the year ended 31 August 20X8, the directors of Skizer judged that it could not complete the project on its own and could not find a suitable entity to jointly develop it. Thus, Skizer decided to sell the project, including all rights to future development. Skizer succeeded in selling the project and, as the project had a nil carrying value, it treated the sale proceeds as revenue in the financial statements. The directors of Skizer argued that IFRS 15 Revenue from Contracts with Customers states that revenue should be recognised when control is passed at a point in time. The directors of Skizer argued that the sale of the rights was part of their business model and that control of the project had passed to the purchaser.

Required:

- (i) Outline the criteria in IAS 38 Intangible Assets for the recognition of an intangible asset and discuss whether these are consistent with the Conceptual Framework. (5 marks)
- (ii) Discuss the implications for Skizer's financial statements for both the years ended 31 August 20X7 and 20X8 if the recognition criteria in IAS 38 for an intangible asset were met as regards the stakes in the development projects above. Your answer should also briefly consider the implications if the recognition criteria were not met. (5 marks)
- (iii) Discuss whether the proceeds of the sale of the development project above should be treated as revenue in the financial statements for the year ended 31 August 20X8. (4 marks)

(b) External disclosure of information on intangibles is useful only insofar as it is understood and is relevant to investors. It appears that investors are increasingly interested in and understand disclosures relating to intangibles. A concern is that, due to the nature of IFRS disclosure requirements, investors may feel that the information disclosed has limited usefulness, thereby making comparisons between companies difficult. Many companies spend a huge amount of capital on intangible investment, which is mainly developed within the company and thus may not be reported. Often, it is not obvious that intangibles can be valued or even separately identified for accounting purposes. The Integrated Reporting Framework may be one way to solve this problem.

Required:

- (i) Discuss the potential issues which investors may have with:
 - accounting for the different types of intangible asset acquired in a business combination
 - the choice of accounting policy of cost or revaluation models, allowed under IAS 38 Intangible Assets for intangible assets
 - the capitalisation of development expenditure. (7 marks)
- (ii) Discuss whether integrated reporting can enhance the current reporting requirements for intangible assets. (4 Marks)

(Total: 25 marks)

48



TOOBASCO (SEP 2018) Walk in the footsteps of a top tutor

- (a) Toobasco is in the retail industry. In the reporting of financial information, the directors have disclosed several alternative performance measures (APMs), other than those defined or specified under International Financial Reporting Standards. The directors have disclosed the following APMs:
 - (i) 'Operating profit before extraordinary items' is often used as the headline measure of the Group's performance, and is based on operating profit before the impact of extraordinary items. Extraordinary items relate to certain costs or incomes which are excluded by virtue of their size and are deemed to be nonrecurring. Toobasco has included restructuring costs and impairment losses in extraordinary items. Both items had appeared at similar amounts in the financial statements of the two previous years and were likely to occur in future years.
 - (ii) 'Operating free cash flow' is calculated as cash generated from operations less purchase of property, plant and equipment, purchase of own shares, and the purchase of intangible assets. The directors have described this figure as representing the residual cash flow in the business but have given no detail of its calculation. They have emphasised its importance to the success of the business. They have also shown free cash flow per share in bold next to earnings per share in order to emphasise the entity's ability to turn its earnings into cash.

- (iii) 'EBITDAR' is defined as earnings before interest, tax, depreciation, amortisation and rent. EBITDAR uses operating profit as the underlying earnings. In an earnings release, just prior to the financial year end, the directors disclosed that EBITDAR had improved by \$180 million because of cost savings associated with the acquisition of an entity six months earlier. The directors discussed EBITDAR at length describing it as 'record performance' but did not disclose any comparable IFRS information and there was no reconciliation to any IFRS measure. In previous years, rent had been deducted from the earnings figure to arrive at this APM.
- (iv) The directors have not taken any tax effects into account when calculating the remaining APMs.

Advise the directors whether the above APMs would achieve fair presentation in the financial statements. (10 marks)

(b) Daveed is a car retailer who leases vehicles to customers under operating leases and often sells the cars to third parties when the lease ends. Net cash generated from operating activities for the year ended 31 August 20X8 for the Daveed Group is as follows:

Year ended 31 August 20X8	\$m
Cash generated from operating activities	345
Income taxes paid	(21)
Pension deficit payments	(33)
Interest paid	(25)
Associate share of profits	12
Net cash generated from operating activities	278

Cash generated from operating activities was calculated using the indirect method.

Net cash flows generated from investing activities included interest received of \$10 million and net capital expenditure of \$46 million excluding the business acquisition at (iii) below.

There were also some errors in the presentation of the statement of cash flows which could have an impact on the calculation of net cash generated from operating activities.

The directors have provided the following information as regards any potential errors:

- (i) Cars are treated as property, plant and equipment when held under operating leases and when they become available for sale, they are transferred to inventory at their carrying amount. In its statement of cash flows for the year ended 31 August 20X8, cash flows from investing activities included cash inflows relating to the disposal of cars (\$30 million).
- (ii) On 1 September 20X7, Daveed purchased a 25% interest in an associate for cash. The associate reported a profit after tax of \$16 million and paid a dividend of \$4 million out of these profits in the year ended 31 August 20X8. As can be seen in the calculation above, the directors included a figure of \$12 million when calculating net cash generated from operating activities. The associate was correctly recorded at \$23 million in the statement of financial position at 31 August 20X8 and profit for the year of \$4 million was included in the statement of profit or loss. No adjustment was made for Daveed's share of the associate's profit when calculating cash generated from operating activities.

- (iii) Daveed also acquired a digital mapping business during the year ended 31 August 20X8. The statement of cash flows showed a loss of \$28 million in net cash inflow generated from operating activities as the effect of changes in foreign exchange rates arising on the retranslation of this overseas subsidiary. The assets and liabilities of the acquired subsidiary had been correctly included in the calculation of the cash movement during the year.
- (iv) During the year to 31 August 20X8, Daveed made exceptional contributions to the pension plan assets of \$33 million but the statement of cash flows had not recorded the cash tax benefit of \$6 million.
- (v) Additionally, Daveed had capitalised the interest paid of \$25 million into property, plant and equipment (\$18 million) and inventory (\$7 million).
- (vi) Daveed has defined operating free cash flow as net cash generated by operating activities as adjusted for net capital expenditure, purchase of associate and dividends received, interest received and paid. Any exceptional items should also be excluded from the calculation of free cash flow.

Prepare:

- (i) a schedule that calculates net cash generated from operating activities to correct any errors above (4 marks)
- (ii) a reconciliation from net cash generated by operating activities to operating free cash flow (as described in note (vi) above) (4 marks)
- (iii) an explanation of the adjustments made in parts (i) and (ii) above. (5 marks)

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

(Total: 25 marks)

49 PLAYER TWO

(a) Player Two, a public limited company, operates a number of retail stores that sell computer and video games. It prepares financial statements in accordance with IFRS Standards. In its financial statement disclosure notes for the year ended 31 December 20X1 it has reported an additional performance measure: adjusted basic EPS (earnings per share). This performance measure does not feature on the face of its statement of profit or loss and other comprehensive income. The following is an extract from its financial statement disclosures:

	20X1
Profit after tax (\$m)	2.5
Adjusting items (\$m)	10.3
Adjusted profit after tax (\$m)	12.8
Shares outstanding (m)	122.2
Adjusted basic EPS	10.5c

Player Two also discloses similar information for the prior period.

The disclosure note states that 'adjusting items' comprise:

- \$6.8 million amortisation charge in relation to acquired brands and intangible assets (20X0: \$6.9 million).
- \$1.4 million restructuring costs (20X0: \$0.9 million)
- \$2.1 million impairment charge relating to retail stores.

The directors of Player Two are aware that the Board has published ED/2019/7 *General Presentation and Disclosures*. This exposure draft outlines the Board's proposals regarding the disclosure of management performance measures – such as 'adjusted profit after tax'.

Required:

With reference to Player Two's disclosure of adjusted EPS, discuss the benefits and limitations of disclosing additional performance measures in the financial statements. (15 marks)

(b) Wrap is a public limited company that operates in the media industry. This industry is currently experiencing little economic growth. Wrap's market capitalisation (the market price per share multiplied by the number of shares outstanding) is less than its net asset value per the financial statements.

In accordance with IAS 36 *Impairment of Assets*, Wrap has carried out various impairment reviews. Cash generating unit D, a magazine publishing business to which goodwill has been allocated, was tested for impairment and was deemed not to be impaired. Wrap has produced the following disclosure note for inclusion in the financial statements:

'The recoverable amount of cash generating unit D has been determined as its value in use. The calculation of value in use was based on cash flow projections that were approved by management. The average discount rate used by Wrap during the year was 10%. The future cash flows of unit D beyond the budgeted period were extrapolated using an 8 per cent growth rate. Management believes that any reasonably possible change in the key assumptions on which D's recoverable amount is based would not cause D's carrying amount to exceed its recoverable amount.'

Required:

Discuss why the information contained in this disclosure may be of limited use to the users of Wrap's financial statements. (8 marks)

Professional marks will be awarded in this question for clarity and quality of presentation. (2 marks)

(Total: 25 marks)

50



MEHRAN Walk in the footsteps of a top tutor

- (a) Mehran is a public limited company. It operates in a number of business sectors, including farming, mining and retail. The directors require advice about how to apply IFRS 13 Fair Value Measurement.
 - Mehran has just acquired a company, which comprises a farming and mining business. Mehran wishes advice on how to fair value some of the assets acquired.

One such asset is a piece of land, which is currently used for farming. The fair value of the land if used for farming is \$5 million. If the land is used for farming purposes, a tax credit of \$0.1 million arises.

Mehran has determined that market participants would consider that the land could have an alternative use for residential purposes. The fair value of the land for residential purposes before associated costs is thought to be \$7.4 million. In order to transform the land from farming to residential use, there would be legal costs of \$200,000, a viability analysis cost of \$300,000 and costs of demolition of the farm buildings of \$100,000. Additionally, permission for residential use has not been formally given by the legal authority and because of this, market participants have indicated that the fair value of the land, after the above costs, would be discounted by 20% because of the risk of not obtaining planning permission.

In addition, Mehran has acquired the brand name associated with the produce from the farm. Mehran has decided to discontinue the brand on the assumption that it is similar to its existing brands. Mehran has determined that if it ceases to use the brand, then the indirect benefits will be \$20 million. If it continues to use the brand, then the direct benefit will be \$17 million. Other companies in this market do not have brands that are as strong as Mehran's and so would not see any significant benefit from the discontinuation. (9 marks)

(ii) Mehran owns a non-controlling equity interest in Erham, a private company, and wishes to fair value it as at its financial year end of 31 March 20X6. Mehran acquired the ordinary share interest in Erham on 1 April 20X4. During the current financial year, Erham has issued further equity capital through the issue of preferred shares to a venture capital fund. As a result of the preferred share issue, the venture capital fund now holds a controlling interest in Erham. The terms of the preferred shares, including the voting rights, are similar to those of the ordinary shares, except that the preferred shares have a cumulative fixed dividend entitlement for a period of four years and the preferred shares rank ahead of the ordinary shares upon the liquidation of Erham. The transaction price for the preferred shares was \$15 per share. Mehran wishes to know the factors which should be taken into account in measuring the fair value of their holding in the ordinary shares of Erham at 31 March 20X6 using a market-based approach. (6 marks)

Required:

Discuss the way in which Mehran should fair value the above assets with reference to the principles of IFRS 13 Fair Value Measurement.

Note: The mark allocation is shown against each of the two issues above.

(b) Mehran has recognised provisions in its financial statements for the year ended 31 March 20X6. It has produced the following provisions disclosure note:

	Customer	Reorganisation	
	refunds	s	Total
	\$m	\$m	\$m
1 April 20X5	10.2	8.0	18.2
Charged to profit or loss	13.1	10.2	23.3
Utilised	(9.1)	(9.6)	(18.7)
31 March 20X6	14.2	8.6	22.8
Of which:			
Current	14.2	8.0	22.2
Non-current	_	0.6	0.6

Provisions for customer refunds reflect the company's expected liability for returns of goods sold in retail stores based on experience of rates of return. Provisions for reorganisations reflect restructuring and redundancy costs, principally in relation to our retail operations as well as restructurings in Finance and IT.

The directors of Mehran have been asked by an investor to explain the accounting for provisions in the financial statements and to explain why the information provided in the provisions disclosure note is useful.

Required:

Explain to the investor the nature of accounting for provisions in financial statements. Your answer should explain the benefits and limitations of the information provided in Mehran's disclosure note. (8 marks)

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

(2 marks)

(Total: 25 marks)

51 CARSOON

Carsoon Co is a public limited. It constructs premises for third parties. It has a year end of 28 February 20X7.

(a) (i) On 1 March 20X6, Carsoon invested in a debt instrument with a fair value of \$6 million and has assessed that the financial asset is aligned with the fair value through other comprehensive income business model. The instrument has an interest rate of 4% over a period of six years. The effective interest rate is also 4%. On 1 March 20X6, the debt instrument is not impaired in any way. During the year to 28 February 20X7, there was a change in interest rates and the fair value of the instrument seemed to be affected. The instrument was quoted in an active market at \$5.3 million but the price based upon an in-house model showed that the fair value of the instrument was \$5.5 million. This valuation was based upon the average change in value of a range of instruments across a number of jurisdictions.

The directors of Carsoon felt that the instrument should be valued at \$5.5 million and that this should be shown as a Level 1 measurement under IFRS 13 Fair Value Measurement. There has not been a significant increase in credit risk since 1 March 20X6, and expected credit losses should be measured at an amount equal to 12-month expected credit losses of \$400,000. Carsoon sold the debt instrument on 1 March 20X7 for \$5.3 million.

The directors of Carsoon wish to know how to account for the debt instrument until its sale on 1 March 20X7. (8 marks)

(ii) Carsoon constructs retail vehicle outlets and enters into contracts with customers to construct buildings on their land. The contracts have standard terms, which include penalties payable by Carsoon if the contract is delayed.

In the year ended 28 February 20X7, Carsoon incurred general and administrative costs of \$10 million, and costs relating to wasted materials of \$5 million. These have been recognised as contract assets.

Due to poor weather, one of the projects was delayed. As a result, Carsoon faced contractual penalties. Carsoon felt that the penalties should be shown as a contingent liability. Additionally, during the year, Carsoon agreed to construct a storage facility on the same customer's land for \$7 million at a cost of \$5 million. This was completed during the current financial year.

The directors of Carsoon wish to know how to account for the \$15 million costs, the penalties, and the storage facility in accordance with IFRS 15 Revenue from Contracts with Customers. (7 marks)

Required:

Advise Carsoon on how the above transactions should be dealt with in its financial statements with reference to relevant International Financial Reporting Standards.

Note: The mark allocation is shown against each of the two issues above.

(b) Carsoon owns the entire share capital of Sinkton, a company that operates in the manufacturing industry and also has a reporting date of 28 February 20X7. Heavy rain in the month prior to the reporting date caused several rivers surrounding Sinkton to burst their banks. As a result, Sinkton's only owned building, in which its factory and head office functions are housed, was flooded. At the start of the reporting period the building was believed to have a remaining useful life of twenty years.

The flooding damaged key plant and machinery as well as some finished goods. Production did not cease, but production volumes declined by two-thirds. The inventory was not insured for flood damage but the machinery was. The directors believe it is probable that the insurers will compensate Sinkton for the machinery damage, but there is doubt about the amount of insurance proceeds that will be received. Confirmation will not be received from the insurers until after the authorisation of the financial statements.

As a result of the flood, Sinkton expects to make an operating loss in the next financial year. The flood has caused a strain on cash flow and the board of directors believe that they will need to make some staff redundancies. However, no firm redundancy plans have been drafted. The directors of Sinkton are worried about the increasing incidence of flooding and expect to move to new premises in five years' time.

Discuss the financial reporting repercussions of the above in Sinkton's financial statements for the year ended 28 February 20X7. (10 marks)

(Total: 25 marks)

52 SKYE

- (a) Skye is a public limited company which has a functional currency of dollars (\$). It has entered into a number of transactions in the year ended 31 May 20X7. The directors require advice about how they should be accounted for.
 - (i) Skye has B shares in issue which allow the holders to request redemption at specified dates and amounts. The legal charter of Skye states that the entity has a choice whether or not to accept the request for repayment of the B shares. There are no other conditions attached to the shares and Skye has never refused to redeem any of the shares up to the current year end of 31 May 20X7. In all other respects the instruments have the characteristics of equity.

Skye also has preference shares in issue which are puttable by the holders at any time after 31 May 20X7. Under the terms of the shares, Skye is only permitted to satisfy the obligation for the preference shares when it has sufficient distributable reserves. Local legislation is quite restrictive in defining the profits available for distribution.

The directors of Skye wish to know if the above financial instruments should be classified as equity items or financial liabilities as at 31 May 20X7. (6 marks)

(ii) Skye has a foreign branch which has a functional currency of dollars (\$). The branch's taxable profits are determined in dinars. On 1 June 20X6, the branch acquired a property for 6 million dinars. The property had an expected useful life of 12 years with a zero residual value. The asset is written off for tax purposes over eight years. The tax rate in Skye's jurisdiction is 30% and in the branch's jurisdiction is 20%. The foreign branch uses the cost model for valuing its property and measures the tax base at the exchange rate at the reporting date.

Exchange rates	\$1 = dinars
1 June 20X6	5
31 May 20X7	6

The directors require advice as to the deferred tax implications of the above. (7 marks)

Required:

Advise the directors of Skye on how the above transactions should be dealt with in its financial statements with reference to relevant International Financial Reporting Standards.

(b) The 2010 Conceptual Framework was criticised for its many notable omissions. One such omission that the 2018 Conceptual Framework addressed was the role of prudence. The revised Conceptual Framework also details factors to consider when selecting a measurement basis. This information should assist the preparers of financial statements when applying an accounting standard that offers a measurement choice (such as IAS 40 Investment Property).

- (i) Discuss what is meant by prudence and the extent to which prudence is consistent with the fundamental qualitative characteristic of faithful representation. (6 marks)
- (ii) With reference to the *Conceptual Framework* discuss the factors that preparers of the financial statements should consider when an accounting standard offers a choice of measurement basis. (6 marks)

(Total: 25 marks)

53 WHITEBIRK

- (a) Whitebirk meets the definition of a small entity in its jurisdiction and complies with the *IFRS for SMEs Standard* (the SMEs Standard). Whitebirk has entered into the following transactions during the year ended 31 May 20X6.
 - (i) Whitebirk requires a new machine, which will be included as part of its property, plant and equipment. Whitebirk therefore commenced construction of the machine on 1 February 20X6, and this continued until its completion which was after the year end of 31 May 20X6. The direct costs were \$2 million in February 2016 and then \$1 million in each subsequent month until the year end. Whitebirk has incurred finance costs on its general borrowings during the period, which could have been avoided if the machine had not been constructed. Whitebirk has calculated that the weighted average cost of borrowings for the period 1 February 31 May 20X6 on an annualised basis amounted to 9% per annum.
 - (ii) Whitebirk has incurred \$1 million of research expenditure to develop a new product in the year to 31 May 20X6. Additionally, it incurred \$0.5 million of development expenditure to bring another product to a stage where it is ready to be marketed and sold.

Required:

- (i) In accordance with IAS 23 Borrowing Cost and IAS 38 Intangible Assets, advise the directors of Whitebirk on how the borrowing costs (note i) and the research and development expenditure (note ii) would be accounted for in the year ended 31 May 20X6. (8 marks)
- (ii) Discuss how the two transactions would be dealt with under the SMEs Standard in the year ended 31 May 20X6. (4 marks)
- (b) One of the reasons why Whitebirk prepares its financial statements using the SMEs Standard is because of the difficulties involved every time a new IFRS Standard is issued. The directors believe that the practicalities and financial statement implications of regularly implementing new IFRS Standards are overly onerous to an entity the size of Whitebirk. However, Whitebirk may have to transition to full IFRS Standards if it continues to grow in size.

(i) Discuss the key practical considerations and financial statement implications that an entity must consider when implementing a new IFRS Standard.

(10 marks)

(ii) Briefly explain the principles outlined in IFRS 1 First Time Adoption of IFRS that must be applied when an entity adopts full IFRS Standards for the first time.

(Total: 25 marks)

54



BUSINESS COMBINATIONS Walk in the footsteps of a top tutor

- (a) You work for an accountancy firm. You have asked to provide advice to clients about the following transactions:
 - (i) On 1 October 20X4, Saag, a listed company, purchased 90% of the ordinary shares of Aloo. Aloo, which ceased trading one week prior to the share purchase, owns a manufacturing facility comprising of land and buildings as well as related equipment. The fair value of the land and buildings is similar to the fair value of the equipment. The acquisition of Aloo only gained legal approval on the basis that all employees who worked at the facility are retained. There are no other assets, including any inventories, or processes transferred as part of the sale.

Saag proposes to account for the purchase of Aloo as a business combination. (7 marks)

(ii) On 1 September 20X4, Bimbi, a listed bank, entered into a business combination with another listed bank, Lental. The business combination has taken place in two stages, which were contingent upon each other. On 1 September 20X4, Bimbi acquired 45% of the share capital and voting rights of Lental for cash. On 1 November 20X4, Lental merged with Bimbi and Bimbi issued new A-shares to Lental's shareholders for their 55% interest.

On 31 August 20X4, Bimbi had a market value of \$70 million and Lental a market value of \$90 million. Bimbi's business represents 45% and Lental's business 55% of the total value of the combined businesses.

After the transaction, the former shareholders of Bimbi excluding those of Lental owned 51% and the former shareholders of Lental owned 49% of the votes of the combined entity. The Chief Operating Officer (COO) of Lental is the biggest individual owner of the combined entity with a 25% interest. The purchase agreement provides for a board of six directors for the combined entity, five of whom will be former board members of Bimbi with one seat reserved for a former board member of Lental. The board of directors nominates the members of the management team. The management comprised the COO and four other members, two from Bimbi and two from Lental. Under the terms of the purchase agreement, the COO of Lental is the COO of the combined entity.

Bimbi proposes to identify Lental as the acquirer in the business combination but requires advice as to whether this is correct. (8 marks)

Advise whether the proposed treatments of the above two transactions are in accordance with IFRS Standards.

Note: The mark allocation is shown against each of the two transactions above.

(b) On 1 January 20X4, Bolo purchased 45% of the ordinary shares of Kata. Consideration paid was \$3 million. The carrying amounts of the net assets of Kata at that date were \$2.4 million and approximated their fair values. The statement of financial position for Kata as at 31 December 20X4 was as follows:

	\$m
Property, plant & equipment	14
Inventories	1
Total assets	15
Share capital	1
Retained earnings	2
Loans	12
Equity and liabilities	15

The directors of Bolo are unsure whether to treat Kata as an associate or a subsidiary in the consolidated financial statements. When relevant, Bolo measures noncontrolling interests using the proportion of net assets method.

Required:

Discuss and compare the impact on the consolidated financial statements of Bolo for the year ended 31 December 20X4 if the investment in Kata is accounted for as:

- a subsidiary, or
- an associate. (8 marks)

Professional marks will be awarded in part (b) for clarity and quality of presentation. (2 marks)

(Total: 25 marks)

55



MARGIE Walk in the footsteps of a top tutor

- (a) Margie, a public limited company, has entered into several share related transactions during the period and wishes to obtain advice on how to account for them.
 - On 1 May 20X2, Margie granted 500 share appreciation rights (SARs) to its (i) 300 managers. All of the rights vested on 30 April 20X4 but they can be exercised from 1 May 20X4 up to 30 April 20X6. At the grant date, the value of each SAR was \$10 and it was estimated that 5% of the managers would leave during the vesting period. The fair value of each SAR is as follows:

Date	Fair value (\$)
30 April 20X3	9
30 April 20X4	11
30 April 20X5	12

All of the managers who were expected to leave employment did leave the company as expected before 30 April 20X4. On 30 April 20X5, 60 managers exercised their options when the intrinsic value of the right was \$10.50 and were paid in cash.

Margie is confused as to whether to account for the SARs under IFRS 2 *Share-based Payment* or IFRS 13 *Fair Value Measurement*, and would like advice as to how the SARs should have been accounted for between the grant date and 30 April 20X5. (6 marks)

(ii) Margie issued shares during the financial year. Some of those shares were subscribed for by employees who were existing shareholders, and some were issued to an entity, Grief, which owned 5% of Margie's share capital. Before the shares were issued, Margie offered to buy a building from Grief and agreed that the purchase price would be settled by the issue of shares.

Margie requires advice about how to account for these two transactions. (5 marks)

(iii) Margie has entered into a contract with a producer to purchase 350 tonnes of wheat. The purchase price will be settled in cash at an amount equal to the value of 2,500 of Margie's shares. Margie may settle the contract at any time by paying the producer an amount equal to the current market value of 2,500 of Margie shares, less the market value of 350 tonnes of wheat. Margie has no intention of taking physical delivery of the wheat.

The directors of Margie are unsure as to whether this transaction is a share-based payment and require advice as to how it should be accounted for in the financial statements. (7 marks)

Required:

Advise the directors of Margie on their various requests above.

Note: The mark allocation is shown against each of the three issues.

- **(b)** The directors of Margie believe that some International Financial Reporting Standards are inconsistent with the *Conceptual Framework*. They have made the following comments:
 - The recognition of an expense in respect of an equity-settled share-based payment scheme with employees is not in line with the *Conceptual Framework's* definition of an expense.
 - The recognition of a liability, rather than income, in respect of non-refundable deposits received from customers is not in line with the Conceptual Framework's definition of a liability.
 - Internally generated brands meet the definition of an asset, and so the fact that IAS 38 *Intangible Assets* prohibits their recognition in the financial statements contradicts the *Conceptual Framework*.

Required:

Discuss the extent to which each of the directors' comments is valid. (7 marks)

(Total: 25 marks)

56 KAYTE

Kayte, a public limited company, operates in a number of industries. It has a reporting date of 30 November 20X3.

One of the industries that Kayte operates in is shipping. Kayte's owns shipping vessels – classified as property, plant and equipment and measured using the cost model-which constitute a material part of its total assets. The economic life of the vessels is estimated to be 30 years, but the useful life of some of the vessels is only 10 years because Kayte's policy is to sell these vessels when they are 10 years old. Kayte estimated the residual value of these vessels at sale to be half of acquisition cost and this value was assumed to be constant during their useful life. Kayte argued that the estimates of residual value used were conservative in view of an immature market with a high degree of uncertainty and presented documentation which indicated some vessels were being sold for a price considerably above carrying value. Broker valuations of the residual value were considerably higher than those used by Kayte. Kayte argued against broker valuations on the grounds that it would result in greater volatility in reporting.

Kayte keeps some of the vessels for the whole 30 years and these vessels are required to undergo an engine overhaul in dry dock every 10 years to restore their service potential, hence the reason why some of the vessels are sold. The residual value of the vessels kept for 30 years is based upon the steel value of the vessel at the end of its economic life. In the current period, one of the vessels had to have its engine totally replaced after only eight years. Normally, engines last for the 30-year economic life if overhauled every 10 years. Additionally, one type of vessel was having its funnels replaced after 15 years but the funnels had not been depreciated separately.

Required:

Advise the directors of Kayte on the accounting issues above. (11 marks)

(b) Throughout its other business operations, Kayte is reliant on skilled workers to design and manufacture high-tech products. Because of the importance of Kayte's workforce to its business operations, the directors wish to disclose the following key performance indicators (KPIs) in the annual integrated report <IR>.

	20X3	20X2
Average employee salary (\$)	30,325	29,956
Revenue per employee (\$)	116,432	102,124
Sick days per employee	4.9	2.1
Employee turnover (%)	18.7	13.9

The national rate of inflation is currently 2%.

Employee turnover has been calculated as the number of employees who left Kayte during the year as a % of the average number of employees throughout the year. The average rate of employee turnover in the industry is 14.1%.

- Briefly discuss some of the factors that management should consider when (i) disclosing KPIs in the reporting entity's <IR>. (4 marks)
- Discuss how the KPIs might be interpreted by users of the <IR>. (ii) (8 marks)

Professional marks will be awarded in part (b) for clarity and quality of presentation. (2 marks)

(Total: 25 marks)



VERGE Walk in the footsteps of a top tutor

- (a) (i) In its annual financial statements for the year ended 31 March 20X3, Verge, a public limited company, had identified the following operating segments:
 - (i) Segment 1 local train operations
 - (ii) Segment 2 inter-city train operations
 - (iii) Segment 3 railway constructions

The company disclosed two reportable segments. Segments 1 and 2 were aggregated into a single reportable operating segment. Operating segments 1 and 2 have been aggregated on the basis of their similar business characteristics, and the nature of their products and services. In the local train market, it is the local transport authority which awards the contract and pays Verge for its services. In the local train market, contracts are awarded following a competitive tender process, and the ticket prices paid by passengers are set by and paid to the transport authority. In the inter-city train market, ticket prices are set by Verge and the passengers pay Verge for the service provided.

(7 marks)

(ii) Verge entered into a contract with a government body on 1 April 20X1 to undertake maintenance services on a new railway line. The total revenue from the contract is \$5 million over a three-year period. The contract states that \$1 million will be paid at the commencement of the contract but although invoices will be subsequently sent at the end of each year, the government authority will only settle the subsequent amounts owing when the contract is completed. The invoices sent by Verge to date (including \$1 million above) were as follows:

Year ended 31 March 20X2 \$2.8 million

Year ended 31 March 20X3 \$1.2 million

The balance will be invoiced on 31 March 20X4. Verge has only accounted for the initial payment in the financial statements to 31 March 20X2 as no subsequent amounts are to be paid until 31 March 20X4. The amounts of the invoices reflect the work undertaken in the period. Verge wishes to know how to account for the revenue on the contract in the financial statements to date.

Market interest rates are currently at 6%.

(7 marks)

Advise Verge on how the above accounting issues should be dealt with in its financial statements for the years ending 31 March 20X2 (where applicable) and 31 March 20X3.

Note: The mark allocation is shown against each of the two issues above.

- (b) The directors of Verge have prepared forecasts for the next five years and they are concerned that the company does not have sufficient liquid assets to fulfil its expansion plans. The directors propose to raise the required funds on 1 April 20X3 in one of the following ways:
 - (i) The issue of 5 million ordinary shares.
 - (ii) The issue of 10 million convertible bonds in exchange for cash proceeds. Interest is payable annually in arrears. The bond holders will be able to redeem the bonds on 31 March 20X6 in the form of cash or a fixed number of Verge's ordinary shares.

The directors are unsure of the impact of the proposals on the financial statements.

Required:

Discuss the impact of the above proposals on the financial statements of Verge. Your answer should consider the potential impact on basic and diluted earnings per share and on the primary users' perception of Verge's financial performance and position.

(9 marks)

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

(Total: 25 marks)

58 ARON

The directors of Aron would like advice about the financial reporting treatment of some financial instrument transactions that took place during the year ended 31 May 20X7.

Convertible bonds

Aron issued one million convertible bonds on 1 June 20X6. The bonds had a term of three years and were issued for their fair value of \$100 million, which is also the par value. Interest is paid annually in arrears at a rate of 6% per annum. Bonds without the conversion option attracted an interest rate of 9% per annum on 1 June 20X6. The company incurred issue costs of \$1 million. The impact of the issue costs is to increase the effective interest rate to 9.38%. At 31 May 20X9 the bondholders can opt to be repaid the par value in cash, or they can opt to receive a fixed number of ordinary shares in Aron.

Share exchange

Aron held 3% holding of the shares in Smart, a public limited company. The investment was designated upon recognition as fair value through other comprehensive income and as at 31 May 20X7 was measured at its fair value of \$5 million. The cumulative gain reported in other comprehensive income and held in equity relating to this investment was \$400,000. On 31 May 20X7, the whole of the share capital of Smart was acquired by Given, a public limited company. Aron received shares in Given with a fair value of \$5.5 million in exchange for its holding in Smart.

Winston bonds

On 1 June 20X6, Aron purchased \$10 million of listed bonds at par and paid in cash. These bonds had been issued by Winston, an entity operating in the video games industry. The bonds are due to be redeemed at a premium on 31 May 20X9, with Aron also receiving 5% interest annually in arrears. The effective rate of interest on the bonds is 15%. Aron often holds bonds until the redemption date, but will sell prior to maturity if investments with higher returns become available. Winston's bonds were deemed to have a low credit risk at inception.

On 31 May 20X7, Aron received the interest due on the bonds. However, there were wider concerns about the economic performance and financial stability of the video games industry. As a result, the quoted price of Aron's investment at 31 May 20X7 was \$9 million, although a pricing model developed by the financial controller that relies on management estimates valued the holding at \$9.5 million. Based on Winston's strong working capital management and market optimism about the entity's forthcoming products, the bonds were still deemed to have a low credit risk.

The financial controller of Aron calculated the following expected credit losses for the Winston bonds as at 31 May 20X7:

12 month expected credit losses \$0.2m Lifetime expected credit losses \$0.4m

Required:

- Discuss the accounting treatment of the convertible bonds in the financial (a) statements for the year ended 31 May 20X7.
- (b) Discuss the accounting treatment of the share exchange in the financial statements for the year ended 31 May 20X7. (6 marks)
- (c) Discuss the accounting treatment of the Winston bonds in the financial statements for the year ended 31 May 20X7. Your answer should explain the impact of the bonds in Aron's statement of cash flows. (10 marks)

(Total: 25 marks)



59 KLANCET Walk in the footsteps of a top tutor

Klancet, a public limited company, is a pharmaceutical company and is seeking advice on several financial reporting issues.

(a) Klancet produces and sells its range of drugs through three separate divisions. In addition, there are two laboratories which carry out research and development activities.

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

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

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

Klancet is uncertain as to whether the research and development laboratories should be reported as two separate segments under IFRS 8 *Operating Segments*, and would like advice on this issue. (8 marks)

(ii) Klancet has agreed to sell a patent right to another pharmaceutical group, Jancy. Jancy would like to use the patent to develop a more complex drug. Klancet will receive publicly listed shares of the Jancy group in exchange for the right. The value of the listed shares represents the fair value of the patent. If Jancy is successful in developing a drug and bringing it to the market, Klancet will also receive a 5% royalty on all sales.

Additionally, Klancet won a competitive bidding arrangement to acquire a patent. The purchase price was settled by Klancet issuing new publicly listed shares of its own.

Klancet's management would like advice on how to account for the above transactions. (6 marks)

Required:

Advise Klancet on how the above transactions should be dealt with in its financial statements with reference to relevant International Financial Reporting Standards.

Note: The mark allocation is shown against each of the two issues above.

(b) On 1 July 20X6, Klancet purchased a debt instrument for its nominal value of \$5 million. The transaction was at fair value. Klancet's business model is to hold financial assets to collect the contractual cash flows but also sell financial assets if investments with higher returns become available. Interest is received at a rate of 4% annually in arrears. The effective rate of interest is 10%.

On 30 June 20X7, the fair value of the debt instrument was \$4.5 million. There has not been a significant increase in credit risk since inception. Expected credit losses are immaterial.

The directors are unsure how to account for this financial instrument. They also wish to know if the correct accounting treatment is consistent with the *Conceptual Framework*.

Required:

- (i) Discuss, with reference to IFRS 9 Financial Instruments, how the above transactions should be dealt with in Klancet's financial statements for the year ended 30 June 20X7. (4 marks)
- (ii) Discuss whether the accounting treatment of this transaction is consistent with the Conceptual Framework. (7 marks)

(Total: 25 marks)



EMCEE Walk in the footsteps of a top tutor

(a) (i) Emcee, a public limited company, is a sports organisation which owns several football and basketball teams. It has a financial year end of 31 May 20X6.

> Emcee purchases and sells players' registrations on a regular basis. Emcee must purchase registrations for that player to play for the club. Player registrations are contractual obligations between the player and Emcee. The costs of acquiring player registrations include transfer fees, league levy fees, and player agents' fees incurred by the club. Also, players' contracts can be extended and this incurs additional costs for Emcee.

> At the end of every season, which also is the financial year end of Emcee, the club reviews its playing staff and makes decisions as to whether they wish to sell any players' registrations. These registrations are actively marketed by circulating other clubs with a list of players' registrations and their estimated selling price. Players' registrations are also sold during the season, often with performance conditions attached. Occasionally, it becomes clear that a player will not play for the club again because of, for example, a player sustaining a career threatening injury or being permanently removed from the playing squad for another reason. The playing registrations of certain players were sold after the year end, for total proceeds, net of associated costs, of \$25 million. These registrations had a carrying amount of \$7 million.

> Emcee would like to know the financial reporting treatment of the acquisition, extension, review and sale of players' registrations in the circumstances outlined above. (9 marks)

(ii) In the consolidated financial statements for 20X6, Emcee recognised a net deferred tax asset of \$16 million. This asset was made up of \$3 million relating to taxable temporary differences and \$19 million relating to the carry-forward of unused tax losses. The local tax regulation allows unused tax losses to be carried forward indefinitely. Emcee expects that within five years, future taxable profits before tax would be available against which the unused tax losses could be offset. This view was based on the budgets for the years 20X6-20Y1. The budgets were primarily based on general assumptions about economic improvement indicators. Additionally, the entity expected a substantial reduction in the future impairments which the entity had recently suffered and this would result in a substantial increase in future taxable profit.

Emcee had recognised material losses during the previous five years, with an average annual loss of \$19 million. A comparison of Emcee's budgeted results for the previous two years to its actual results indicated material differences relating principally to impairment losses. In the interim financial statements for the first half of the year to 31 May 20X6, Emcee recognised impairment losses equal to budgeted impairment losses for the whole year. In its financial statements for the year ended 31 May 20X6, Emcee disclosed a material uncertainty about its ability to continue as a going concern. The current tax rate in the jurisdiction is 30%.

(8 marks)

Required:

Discuss how the above matters should be dealt with in Emcee's financial statements.

Note: The mark allocation is shown against each of the two issues above.

Developing a framework for disclosure is at the forefront of current debate and there (b) are many bodies around the world attempting to establish an overarching framework to make financial statement disclosures more effective, coordinated and less redundant. Some argue that disclosure notes are too lengthy and numerous. Others argue that there is no such thing as too much 'useful' information for users.

Required:

Discuss why it is important to ensure the optimal level of disclosure in annual reports, and the role of materiality when preparing financial statement disclosure notes. (8 marks)

(Total: 25 marks)

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GASNATURE Walk in the footsteps of a top tutor



Answer debrief

- Gasnature is a public limited company involved in the production and trading of natural gas and oil. It prepares its financial statements using International Financial Reporting Standards. The directors require advice about the accounting treatment of some of the transactions that Gasnature has entered into during the year.
 - Gasnature jointly owns an underground storage facility with another entity, Gogas. Both parties extract gas from offshore gas fields, which they own and operate independently from each other. Gasnature owns 55% of the underground facility and Gogas owns 45%. They have agreed to share services and costs accordingly, with decisions regarding the storage facility requiring unanimous agreement of the parties. Local legislation requires the decommissioning of the storage facility at the end of its useful life.

Gasnature wishes to know how to treat the agreement with Gogas including any obligation or possible obligation arising on the underground storage facility.

(7 marks)

(ii) Gasnature has entered into a 10-year contract with Agas for the purchase of natural gas. Gasnature has made an advance payment to Agas for an amount equal to the total quantity of gas contracted for 10 years which has been calculated using the forecasted price of gas. The advance carries interest of 6% per annum, which is settled by way of the supply of extra gas. Fixed quantities of gas have to be supplied each month and there is a price adjustment mechanism in the contract whereby the difference between the forecasted price of gas and the prevailing market price is settled in cash monthly. If Agas does not deliver gas as agreed, Gasnature has the right to claim compensation at the current market price of gas.

Gasnature wishes to know whether the contract with Agas should be accounted for under IFRS 9 Financial Instruments. (6 marks)

Required:

Discuss, with reference to IFRS Standards, how Gasnature should account for the above agreement and contract

(b) Gasnature's institutional shareholders invest in a wide-range of entities. Gasnature's directors are concerned that certain IFRS and IAS Standards permit entities to choose between different measurement bases and presentation methods. They believe that these choices hinder its shareholders from comparing Gasnature to other entities on a like-for-like basis.

Required:

Outline the main accounting choices permitted by IAS 16 Property, Plant and Equipment and IAS 20 Accounting for Government Grants and Disclosure of Government Assistance and discuss the potential impact of these on investors' analysis of financial statements. (10 marks)

Professional marks will be awarded in part (b) for clarity and quality of presentation. (2 marks)

(Total: 25 marks)



Calculate your allowed time, allocate the time to the separate parts.....



EVOLVE Walk in the footsteps of a top tutor



Answer debrief

- (a) Evolve is a real estate company, which is listed on the stock exchange and has a year end of 31 August.
 - (i) At 31 August 20X6, Evolve controlled a wholly owned subsidiary, Resource, whose only assets were land and buildings, which were all measured in accordance with International Financial Reporting Standards. On 1 August 20X6, Evolve published a statement stating that a binding offer for the sale of Resource had been made and accepted and, at that date, the sale was expected to be completed by 31 August 20X6. The non-current assets of Resource were measured at the lower of their carrying amount or fair value less costs to sell at 31 August 20X6, based on the selling price in the binding offer. This measurement was in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. However, Evolve did not classify the non-current assets of Resource as held for sale in the financial statements at 31 August 20X6 because there were uncertainties regarding the negotiations with the buyer and a risk that the agreement would not be finalised. There was no disclosure of these uncertainties and the original agreement was finalised on 20 September 20X6. (7 marks)
 - (ii) Evolve operates in a jurisdiction with a specific tax regime for listed real estate companies. Upon adoption of this tax regime, the entity has to pay a single tax payment based on the unrealised gains of its investment properties. Evolve purchased Monk whose only asset was an investment property for \$10 million. The purchase price of Monk was below the market value of the investment property, which was \$14 million, and Evolve chose to account for the investment property under the cost model. However, Evolve considered that the transaction constituted

a 'bargain purchase' under IFRS 3 Business Combinations. As a result, Evolve accounted for the potential gain of \$4 million in profit or loss and increased the 'cost' of the investment property to \$14 million. At the same time, Evolve opted for the specific tax regime for the newly acquired investment property and agreed to pay the corresponding tax of \$1 million. Evolve considered that the tax payment qualifies as an expenditure necessary to bring the property to the condition necessary for its operations, and therefore was directly attributable to the acquisition of the property. Hence, the tax payment was capitalised and the value of the investment property was stated at \$15 million. (6 marks)

Required:

Advise Evolve on how the above transactions should be correctly dealt with in its financial statements with reference to relevant International Financial Reporting Standards.

Note: The mark allocation is shown against each of the two issues above.

(b) The International Accounting Standards Board (the Board) is undertaking a broad-based initiative to explore how disclosures in financial reporting can be improved. The Disclosure Initiative is made up of a number of implementation and research projects, one of which is concerned with materiality. The Board have now issued a Practice Statement in which it provides further guidance on the application of materiality to financial statements.

Required:

Discuss why the concept of materiality is so important to preparers and users of financial statements.

Your answer should include reference to the Board's materiality Practice Statement.
(10 marks)

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

(Total: 25 marks)



Calculate your allowed time, allocate the time to the separate parts.....

63 ARTWRIGHT

(a) Artwright trades in the chemical industry. The entity has development and production operations in various countries. It has entered into an agreement with Jomaster under which Artwright will licence Jomaster's know-how and technology to manufacture a chemical compound, Volut. The know-how and technology has a fair value of \$4 million. Artwright cannot use the know-how and technology for manufacturing any other compound than Volut. Artwright has not concluded that economic benefits are likely to flow from this compound but will use Jomaster's technology for a period of three years. Artwright will have to keep updating the technology in accordance with Jomaster's requirements. The agreement stipulates that Artwright will make a non-refundable payment of \$4 million to Jomaster for access to the technology. Additionally, Jomaster will also receive a 10% royalty from sales of the chemical compound.

Additionally, Artwright is interested in another compound, Yacton, which is being developed by Jomaster. The compound is in the second phase of development. The intellectual property of compound Yacton has been put into a newly formed shell company, Conew, which has no employees. The compound is the only asset of Conew. Artwright is intending to acquire a 65% interest in Conew, which will give it control over the entity and the compound. Artwright will provide the necessary resources to develop the compound.

The directors of Artwright require advice about how the above events are accounted for in accordance with International Financial Reporting Standards. (8 marks)

(b) Artwright has entered into three derivative contracts during the year ended 30 April 20X4, details of which are as follows:

	Initial recognition at fair value	Fair value 30 April 20X4	Details
A	Nil	\$20m (liability)	Artwright believes that oil prices are due to rise in the future so during the year has entered into futures contracts to buy oil at a fixed price. Artwright has no exposure to oil prices in the course of its business. In fact, oil prices have fallen resulting in the loss at the year-end.
В	\$1m	\$9m (liability)	Artwright has an investment in equity designated to be measured at fair value through other comprehensive income. Artwright is concerned the investment will fall in value and it wishes to cover this risk. Thus during the year it entered into derivative B to cover any fall in value and designated this as a hedging instrument as part of a fair value hedge. In fact, by the reporting date, the asset increased in value by \$8.5 million.
С	Nil	\$25m (asset)	Artwright is concerned about the potential for raw material prices to rise. It managed this risk by entering into derivative C – a futures contract. This arrangement has been designated as a cash flow hedge. At the year-end the raw material prices have risen, potentially giving the company an increased future cost of \$24 million.

Assume that all designated hedges meet the effectiveness criteria outlined in IFRS 9 *Financial Instruments*.

The directors of Artwright would like an outline of the hedge effectiveness criteria and also require advice on how the three derivatives should be accounted for in the financial statements for the year ended 30 April 20X4. (9 marks)

(c) Artwright's functional currency is the dollar. Artwright took out a foreign currency loan of 5 million dinars at a fixed interest rate of 8% on 1 May 20X3. The effective rate of interest on the loan is also 8%. Annual interest payments commenced on 30 April 20X4. The loan will be repaid on 30 April 20X5. Currency rates during the year are as follows:

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

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

The directors of Artwright require advice on how to account for the loan and interest in the financial statements for the year ended 30 April 20X4. (8 marks)

Required:

With reference to relevant IFRS Standards, respond to the directors requests.

Note: The mark allocation is shown against each of the three issues above.

(Total: 25 marks)

64 LUCKY DAIRY

(a) (i) The Lucky Dairy, a public limited company, produces milk for supply to various customers. It is responsible for producing twenty five per cent of the country's milk consumption. The company owns cows and heifers (young female cows).

The herd as at 31 May 20X2 is comprised as follows:

70,000 – 3 year old cows (all purchased before 1 June 20X1)

25,000 – 2 year old heifers purchased for \$46 each on 1 December 20X1

There were no animals born or sold in the year. The per unit values less estimated costs to sell were as follows:

	\$
2 year old animal at 31 May 20X1	50
2 year old animal at 31 May 20X2	55
3 year old animal at 31 May 20X2	60

The directors would like advice on how the herd should be accounted for in its primary financial statements for the year ended 31 May 20X2. Advice about disclosure notes is not required. (6 marks)

(ii) On 1 December 20X1 Lucky Dairy purchased interest-bearing bonds in Jags, another listed company, for \$10 million and classified these assets to be measured at amortised cost. Just prior to the date of the bond purchase, Jags had released an interim financial report that demonstrated encouraging year-on-year growth and a strong financial position. As such, external agencies had graded the bonds as having a low credit risk. In May 20X2, Jags released its annual financial statements and these showed a weak trading performance in the final six months of its reporting period as well as a large decline in the cash generated from its operations compared to the prior year. These financial statements show that, at the period end, Jags was relatively close to breaching its loan covenants. The listed bond price of Jags has fallen by 20% since December 20X1 despite an overall increase in bond prices for other listed entities in the same sector. It has been reported that external agencies are reviewing and re-assessing the credit rating of Jags. Despite encountering financial difficulties, Jags has met all of its obligations to its lenders and bond holders.

The directors of Lucky Dairy would like advice on how the above information will impact the carrying amount of its financial assets. (8 marks)

Required:

Advise Lucky Dairy on how the above transactions should be correctly dealt with in its financial statements with reference to relevant International Financial Reporting Standards.

Note: The mark allocation is shown against each of the two issues above.

(b) Lucky Dairy's directors have been reviewing the International Integrated Reporting Council's Framework for Integrated Reporting. The directors believe that International Financial Reporting Standards are already extensive and provide stakeholders with a comprehensive understanding of an entity's financial position and performance for the year. In particular, statements of cash flow enable stakeholders to assess the liquidity, solvency and financial adaptability of a business. They are concerned that any additional disclosures could be excessive and obscure the most useful information within a set of financial statements. They are therefore unsure as to the rationale for the implementation of a separate, or combined, integrated report.

Required:

Discuss the extent to which statements of cash flow provide stakeholders with useful information about an entity and whether this information would be improved by the entity introducing an Integrated Report. (9 marks)

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

(Total: 25 marks)

UK GAAP FOCUS

65 STEM (SEP/DEC 2021)

Stem Co is a parent of a manufacturing company. It has 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.

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.

Emphasis Co is not held by Stem Co as part of an investment portfolio.

Required:

(a) Explain the key differences between IFRS 3 Business Combinations and FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland.

Note: there is no need to refer to any exhibit when answering part (a). (7 marks)

(b) In accordance with FRS 102, discuss why Stem Co's investment in Emphasis Co should be classified as a jointly controlled entity and how Stem Co should account for its interest at 1 January 20X7 in the consolidated financial statements.

Note: candidates should show any relevant entries required in the accounting records of Stem Group. (8 marks)

(Total: 15 marks)

66 SITKA (MAR/JUN 2021)

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. Sitka Co uses FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in its individual financial statements and IFRS in the group financial statements. The year end of the company is 31 December 20X7.

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. Cent Co is a UK company.

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 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.

Part disposal of Martlett

Sitka Co prepares separate financial statements in accordance with FRS 102. 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 at cost less any impairment. 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.

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) 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 in accordance with FRS 102. (4 marks)
- (b) Discuss and demonstrate how the disposal of a 45% interest and the retained interest of 15% in Martlett Co should be accounted for in the separate financial statements of Sitka Co at the date of disposal in accordance with FRS 102. (8 marks)
- (c) Discuss briefly whether the fair value of the two assets acquired on the acquisition of Billing Co would be different if accounted for in accordance with FRS 102 and IFRS 13 Fair Value Measurement. (5 marks)

(Total: 17 marks)

67 CORBEL (SEP/DEC 2020)

Corbel Co is a UK small and medium enterprise (SME) trading in the perfume sector. It has recently acquired a company for its brand 'Jengi', purchased two additional brand names, and has announced plans to close its Italian stores. Corbel Co also opened a new store on a prime site in London. The current financial year end is 31 December 20X7.

Acquisition of Jengi Co

On 1 January 20X7, Corbel Co acquired 100% of Jengi Co. Both companies operate in the perfume sector. Corbel Co intends to merge the manufacture of Jengi Co's products into its own facilities and close Jengi Co's manufacturing unit. Jengi Co's brand name is well known in the sector, retailing at premium prices, and therefore, Corbel Co will continue to sell products under the Jengi brand name after its registration has been transferred and its manufacturing units have been integrated. The directors of Corbel Co believe that most of the value of Jengi Co was derived from the brand and there is no indication of the impairment of the brand at 31 December 20X7.

Acquisition of perfume brands

In addition to owning the Jengi Co brand, Corbel Co has acquired two other perfume brand names to prevent rival companies acquiring them. The first perfume (Locust) has been sold successfully for many years and has an established market. The second is a new perfume which has been named after a famous actor (Clara) who intends to promote the product. The directors of Corbel Co believe that the two perfume brand names have an indefinite life.

Plan to close and sell stores

Corbel Co approved and announced a plan to close and sell all six Italian stores on 31 December 20X7. The six stores will close after a liquidation sale which will last for three months. Management has committed to a formal plan for the closure of the six stores and has also started an active search for a single buyer for their assets. The stores are being closed because of the increased demand generated by Corbel Co's internet sales. A local newspaper has written an article suggesting that up to 30 stores may be closed with a loss of 500 jobs across the world, over the next five years. The directors of Corbel have denied that this is the case.

Corbel Co's primary store

Corbel Co's primary store is located in central London. It has only recently been opened at a significant cost with the result that management believes it will make a loss in the current financial year to 31 December 20X7. This loss making is not of concern as the performance is consistent with expectations for such a new and expensive store and management believes that the new store will have a positive effect on Corbel Co's brand image. If impairment testing of the primary store were to be required, then Corbel Co would include the cash flows from all internet sales in this assessment. The goods sold via the internet are sourced from either Corbel Co's central distribution centre or individual stores. Internet sales are either delivered to the customer's home or collected by the customer from the store supplying the goods.

Discuss the following accounting issues relating to Corbel Co's financial statements for the year ended 31 December 20X7 in accordance with FRS 102, The Financial Reporting Standard applicable in the UK and Republic of Ireland:

- (a) whether the Jengi Co brand name should be tested for impairment, and whether it can be accounted for as a separate cash generating unit after the integration of the manufacturing units

 (4 marks)
- (b) whether the two perfume brand names (Locust and Clara) can be accounted for as if they have an indefinite life and how to determine their useful life (6 marks)
- (c) how to account for the proposed closure of the six stores and the suggested closure of the remaining stores, and how this contrasts with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations; and (6 marks)
- (d) whether the primary store should be tested for impairment at 31 December 20X7 and whether the internet sales can be attributed to this store. (4 marks)

(Total: 20 marks)

68 LERIA (MAR 2020)

Leria Co owns a football club, Real Verde, in the UK. The football club reports under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. As a result, it has material intangible assets which relate to the contract costs of its players.

Players' registration contract costs are shown as intangible assets and are initially recognised at the fair value of the consideration paid for their acquisition. However, subsequently, players' contracts are often re-negotiated at a cost. Also, players' contracts may contain contingent performance conditions where individual players may be paid a bonus based on their success in terms of goals scored or the success of the football team as a whole. These bonuses represent additional contract costs.

For impairment purposes, Leria Co does not consider that it is possible to determine the value-in-use of an individual player unless the player were to suffer a career threatening injury and cannot play in the team. Players only generate direct cash flows when they are sold to another football club.

Required:

- (a) Discuss the key differences between accounting for intangible assets in accordance with FRS 102 and IFRS Standards. (5 marks)
- (b) Discuss how to account, in accordance with FRS 102, for the players' contract costs (including the contingent performance conditions), any impairment which might be required to these non-current assets and whether a player can be considered a single cash generating unit. (7 marks)

(Total: 12 marks)

69 DIGIWIRE (SEP/DEC 2019)

Pension plan

Digiwire Co has a UK subsidiary which provides a pension plan for its employees. From 1 September 20X6, Digiwire Co decided to curtail the plan and to limit the number of participants. The employees were paid compensation from the plan assets and some received termination benefits due to redundancy. Due to the curtailment, the current monthly service cost changed from \$9 million to \$6 million. The relevant financial information relating to the plan is as follows:

Date	Net defined liability	Discount rate
	\$m	%
1 January 20X6	30	3
1 September 20X6	36	3.5
31 December 20X6	39	3.7

True and fair override

Concerns have been raised about the operation of the true and fair override in UK law. The importance of the true and fair requirement in corporate financial statements is fundamental and is necessarily dependent on estimates and judgement.

Required:

- (a) Describe the differences in the guidance on accounting for termination benefits under FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and IAS 19 Employee Benefits. (3 marks)
- (b) If amendments to IAS 19 in respect of plan amendments, curtailments and settlements were adopted by FRS 102, calculate and discuss the impact on the FRS 102 calculation of net interest and current service cost of the subsidiary for the year ended 31 December 20X6. (8 marks)
- (c) Discuss the issues which may arise in the application of the true and fair override in financial statements in the UK and whether faithful representation and comparability may be affected by such a regulation. (6 marks)

(Total: 17 marks)

70 CRYPTO (MAR/JUN 2019)

Crypto operates in the power industry, and owns 45% of the voting shares in Kurran. Kurran has four other investors which own the remaining 55% of its voting shares and are all technology companies. The largest of these holdings is 18%. Kurran is a property developer and purchases property for its renovation potential and subsequent disposal. Crypto has no expertise in this area and is not involved in the renovation or disposal of the property.

The board of directors of Kurran makes all of the major decisions but Crypto can nominate up to four of the eight board members. Each of the remaining four board members are nominated by each of the other investors. Any major decisions require all board members to vote and for there to be a clear majority. Thus, Crypto has effectively the power of veto on any major decision. There is no shareholder agreement as to how Kurran should be operated or who will make the operating decisions for Kurran.

The directors of Crypto believe that Crypto has joint control over Kurran because it is the major shareholder and holds the power of veto over major decisions.

Crypto has also entered into a contract to purchase 80% of the shares of an overseas subsidiary. The directors are concerned about the procedures required to translate the results of a foreign subsidiary into Crypto's presentational currency to prepare the consolidated financial statements. Specifically, the directors are concerned about the translation process and the treatment of cumulative foreign exchange gains and losses, particularly as regards the non-controlling interest (NCI).

Required:

- (a) As far as the definition of control is concerned, discuss the key differences between FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and IFRS 10 Consolidated Financial Statements. Your answer should also briefly explain the classification of joint arrangements in IFRS 11 Joint Arrangements. (6 marks)
- (b) Discuss the advice which should be given to Crypto regarding how Kurran should be accounted for under FRS 102. (6 marks)
- (c) Advise Crypto on the FRS 102 procedures to be followed when translating the results of a foreign subsidiary into the presentation currency of the group. Your answer should also set out any differences between FRS 102 and IAS 21 The Effects of Changes in Foreign Exchange Rates as regards the treatment of cumulative foreign exchange gains and losses including those relating to the NCI. (5 marks)

(Total: 17 marks)

71 FILL (DEC 2018)

(a) On 1 December 20X6, Fill purchased an open cast coal mine in the UK. The negotiation and purchase of a coal mining licence took a substantial amount of time to complete, and resulted in Fill incurring significant borrowing costs. Fill also acquired equipment which will be used for the construction of various mines throughout the UK. Fill wishes to capitalise the borrowing costs on the acquisition of the licence and the equipment.

However, during the last six months of the year ended 30 November 20X8, there has been a significant decline in the spot price of coal and it is expected that future reductions in selling prices may occur. Currently, the forward contracts being signed over the next two years by Fill indicate a reduction in the price of coal. At 30 November 20X8, the mine has a useful remaining life of four years. As a result of the decline in the price of coal, Fill has decided to sell the mine and has approached several potential buyers.

Required:

Advise the directors of Fill on how to treat the above events under FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland. (8 marks)

(b) Several years ago, Fill had purchased an interest of 10% in another mining company. However, over the last two years, Fill has made several other purchases of shares with the result that, at 30 November 20X8, it owned 51% of the equity of the mining company. Fill had incurred significant legal and advisory costs in acquiring control. The mining company has reserves which contain different grades of coal. As the entity cannot process some high quality coal for several years, contingent consideration for the purchase of the entity has been agreed. On the date that Fill gained control of the mining company, the fair value of the contingent consideration was estimated at \$10 million.

Advise the directors of Fill on the differences in treatment of the above purchase of the mining company between IFRS 3 Business Combinations and FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland. (7 marks)

(Total: 15 marks)

72 SKIZER (SEP 2018)

Skizer is a pharmaceutical company which develops new products with other pharmaceutical companies that have the appropriate production facilities. Stakes in development projects When Skizer acquires a stake in a development project, it makes an initial payment to the other pharmaceutical company. It then makes a series of further stage payments until the product development is complete and it has been approved by the authorities. In the financial statements for the year ended 31 August 20X7, Skizer has treated the different stakes in the development projects as separate intangible assets because of the anticipated future economic benefits related to Skizer's ownership of the product rights. However, in the year to 31 August 20X8, the directors of Skizer decided that all such intangible assets were to be expensed as research and development costs as they were unsure as to whether the payments should have been initially recognised as intangible assets. This write off was to be treated as a change in an accounting estimate.

Required:

- (a) Outline the criteria in FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland for the recognition of an intangible asset and discuss whether these are consistent with the Conceptual Framework. (6 marks)
- (b) Discuss the required treatment under FRS 102 for the stakes in the development projects for both the years ended 31 August 20X7 and 20X8 assuming that the recognition criteria for an intangible asset were met. Your answer should also briefly consider the implications if the recognition criteria were not met. (5 marks)
- (c) Discuss the key differences between International Financial Reporting Standards and FRS 102 with regards to the recognition of intangible assets. (4 marks)

(Total: 15 marks)

73 BOBARRA

- (a) Shortly before the financial year-end, Bobarra signed a letter of intent to buy a group of companies in the United Kingdom (UK). The UK group was diverse in nature and included subsidiaries, which the entity was prepared to sell. One subsidiary was operating in a country that was engaged in civil war and so the group had lost managerial control over the entity. Another subsidiary was being held by the group specifically to make a profit on its resale. Bobarra has little experience of UK company legislation and UK Generally Accepted Accounting Practice (UK GAAP).
 - The directors require advice on the requirements to prepare group financial statements in the UK and any relevant exemptions and exclusions from consolidation available in the UK. (9 marks)
- (b) At 30 November 20X6, three people own the shares of Bobarra. The finance director owns 60%, and the operations director owns 30%. The third owner is a passive investor who does not help manage the entity. All ordinary shares carry equal voting rights. The wife of the finance director is the sales director of Bobarra. Their son is currently undertaking an apprenticeship with Bobarra and receives a salary of \$30,000 per annum, which is normal compensation. The finance director and sales director have set up a trust for the sole benefit of their son. The trust owns 60% of the ordinary shares of Santarem which carry voting rights. The finance director and sales director are trustees of the trust.

Finally, Bobarra owns 100% of the shares in Alucant, which in turn owns 100% of the shares in Cantor. Alucant also has a 80% holding of the shares of Drumby. There have been transactions in the year between Bobarra and Drumby.

The directors of Bobarra require advice on the identification of related parties and the preparation of related party disclosure in respect of its separate financial statements for the year ending 30 November 20X6 in accordance with IAS 24 Related Party Disclosures and FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland (7 marks)

Required:

Advise Bobarra on the matters set out above.

74 HARRIS

The directors of Harris are looking at the requirements of IFRS 3 *Business Combinations* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. The directors would like advice on the accounting treatment of goodwill because the entity is preparing to purchase a UK subsidiary at a competitive price.

The directors are also concerned about the differences between IAS 12 *Income Taxes* and FRS 102 with regards to the recognition of deferred tax assets and liabilities.

Required:

- (a) Discuss the key differences with regards to accounting for goodwill under IFRS 3 and FRS 102. (9 marks)
- (b) Discuss the differences in the general recognition principles between IAS 12 and FRS 102 in accounting for deferred tax. (6 marks)

(Total: 15 marks)

(Total: 16 marks)

75 ROWLING

Rowling, a public limited company, purchases and develops numerous intangible assets. Two of the directors of Rowling are qualified accountants who were trained in International Financial Reporting Standards. The directors of Rowling are aware that the UK Financial Reporting Council in the UK has published a range of Financial Reporting Standards (FRSs) – FRS 100, 101, 102 and 105 – but do not understand the scope of these or what entities they apply to. Moreover they require an explanation of how International Financial Reporting Standards and FRS 102 differ with regards to the recognition of intangible assets.

Required:

Prepare a draft memorandum to the directors setting out:

- the scope of FRS 100, FRS 101, FRS 102 and FRS 105 (9 marks)
- the differences between IFRS Standards and FRS 102 with regards to the recognition of intangible assets. (6 marks)

(Total: 15 marks)

76 TOTO

On 1 January 20X1, Toto enters into a lease. The lease term is three years and the asset, which is not specialised, has a useful economic life of ten years. Ownership of the asset does not transfer to Toto at the end of the lease term. Toto must make lease payments annually in arrears. No other fees or costs are required. The lease payments are material to Toto's financial statements.

Required:

Compare the impact of the above on the financial statements of Toto for the year ended 31 December 20X1 if the lease is accounted for in accordance with:

- IFRS 16 Leases, or
- FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland.

Your answer should make reference to key financial statement ratios. (15 marks)

77 HOWEY

Howey, a public limited company, intends to dispose of part of its business. This meets the criteria in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* to be classified as a discontinued operation. They are also considering acquiring a subsidiary exclusively with a view to resale.

Required:

- (a) Discuss the differences between the treatment of non-current assets held for sale and discontinued operations under FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and International Financial Reporting Standards. (9 marks)
- (b) Discuss why a UK entity might choose to adopt FRS 102 instead of applying IFRS Standards. (6 marks)

(Total: 15 marks)

78 LOKI

On 1 January 20X1, Loki purchased 70% of the ordinary shares of Odin for cash consideration of \$300 million. The identifiable net assets of Odin at this date had a carrying amount of \$200 million and a fair value of \$280 million. If accounting standards permit, Loki measures non-controlling interests (NCI) at acquisition at fair value. The fair value of the NCI at acquisition was \$120 million.

On 31 December 20X2, Loki performed an impairment review. Odin was deemed to be a cash generating unit. The net assets of Odin (excluding goodwill) were carried in the consolidated financial statements of the Loki group at \$260 million. The recoverable amount of Odin was calculated as \$350 million.

If required, you should assume that the goodwill arising on the acquisition of Odin was attributed a useful economic life of ten years as at the acquisition date.

Required:

- (a) Discuss, with calculations, how the impairment review should be accounted for in accordance with IFRS Standards. (6 marks)
- (b) Discuss, with calculations, how the impairment review should be accounted for if Loki prepared its financial statements in accordance with FRS 102. (9 marks)

(Total: 15 marks)

Section 2

ANSWERS TO PRACTICE QUESTIONS

SECTION A QUESTIONS – GROUP FINANCIAL STATEMENTS

1



CHUCKLE (SEP/DEC 2021) Walk in the footsteps of a top tutor



Key answer tips

This is a very groups heavy Q1, with less emphasis on non-group IFRS knowledge compared to previous sittings. This shows how important it is not to question spot as variances between mark allocations can arise between exam sittings. However, what is always guaranteed is that groups will be set within Q1.

This question considered a group with complicated classification issues, caused by changing levels of investment over a period of time and has a statement of financial position emphasis. The question required the understanding and discussion of the basic concepts underpinning the classification of investments within the group (e.g. associates requiring significant influence, subsidiaries requiring control) and how they could be affected by chages in the group structure (in this case, a step acquisition). It also included more complicated calculations of group accounting treatments (equity accounting and goodwill calculations).

The required calculation elements do still specify that explanations are needed. Narrative marks will be given for addressing these areas.

Keep an eye on the dates in the requirements. Part (a)(i) is interested in the classifications on 1 April 20X2, part (a)(ii) is concerned with 31 March 20X6 (both dates being prior to the step-acquisition of 18% and so shareholdings are 30%), whilst (a)(iii) and (b) are concerned with issues at 1 April 20X6 (which is after the step acquisition, when shareholdings of 48% were held).

It may help to attempt part (b)(i) and (b)(ii) simulatenously. Set up a template for the goodwill calculation (needed for (b)(ii). Then fill in the template with any relevant figures you spot as you attempt to explain the affects on the net assets at acquisition of the fair value adjustments in (b)(i).

(a) 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, i.e. 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.



Tutorial note

As well as discussing the factors contributing to the correct accounting treatment (in this case, the elements suggesting significant influence over Grin), you should also address why alternative treatments are **not appropriate**, particularly if factors in the scenario can be used to support these conclusions. This is alluded to in the requirement with the 'as oppose to a subsidiary' comment, but can be applied more generally.

Marks will be allocated for highlighting why Grin is not a subsidary of Chuckle (due to the lack of control), as well as why Grin is an associate (due to the significant influence).

The strategy applied to this particular model answer is to prove that control does not exist first and foremost, and then to address the issue of significant influence (see below). Do not fret if your approach was the opposite (to focus on why significant influence is exerted, and then to discuss why control is not appropriate). You'll still get the credit!

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 under the heading 'Investment in associate' which at 31 March 20X6 would be valued at \$118.6 million (\$100m + (30% × (\$348m - \$286m))).



Tutorial note

The points above should represent the achievable marks within this requirement. Make sure you understand the accounting of an associate.

The subsequent points below are more complicated. They address the additional explanations as specified in the requirement. Note that they are not adjustments to the equity accounting described above (as the revaluation is already correctly accounted for within the \$348m net assets of Grin).

Candidates need to appreciate that an upwards revaluation of land would create entries to the revaluation surplus (and OCI) of the associate. In the group accounts, equity accounting leads to a share (30%) of the post-acquisition revaluation surplus being incorporated in the group equity within the CSOFP.

Commonly in exam questions, movements in an associate's net assets are created by impacts to profits, the parent's share of which will affect the CSOFP within retained earnings. In this question, there is enough information to identify that the post-acquisition movements in the associate's net assets are accounted for within different reserves.

Well done if you have noted the deferred tax impacts caused by the revaluation in the associate. It is fair to suggest that this is a higher skill mark compared to the other issues addressed in the answer.

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 \times 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\% \times $50m$) 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.



Tutorial note

For (b)(i) and (b)(ii) candidates must apply the assumption that Chuckle has control of Grin after the step acquisition. This creates a step acquisition where control is achieved. Grin is now a subsidiary. This assumption is provided within the requirement.

Do not perservere with any conclusions that you may have made from (a)(iii) that contradict the assumption.

Also, the assumption does provide a good hint as to what the conclusion of a(iii) should have been!

(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, at the point control is achieved, 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.



Fair value adjustments are very common issues within the SBR exam. Candidates must be well-versed in the need for fair value adjustments upon consolidation. The basic effects of the fair value adjustments to land, inventory and intangibles should be easy marks for well-prepared students. (Note: not quite so easy if this is your first attempt at an exam standard question, but trust me, you'll see fair value adjustments again and again as you continue to practice exam-standard questions.)

The effect of fair value adjustments upon deferred tax is less commonly tested. In the group accounts, fair value adjustments cause changes in the carrying amount which are not reflected in the tax base. Therefore, temporary differences arise, causing deferred tax. Remember, the accounting treatment of the deferred tax should match the accounting treatment of the transaction causing the deferred tax. Therefore, any entry to record deferred tax on fair value adjustments is allocated to goodwill (see part (b)(ii)).

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 date, it should be recognised on acquisition as part of Grin's net assets. An overall increase in net assets of \$8 million (\$10m - \$2m) arises.

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.



In the group accounts, treat a step acquisition that achieves control as if the group has:

- sold the initial investment (the 30%)
- bought back the entire investment (the 48%) in one go at the point control is achieved.

This means the 30% is revalued to fair value (in this case, with gains or losses taken to profit or loss) and the goodwill is calculated as if the entire 48% was purchased in one go. Consideration will include the amount paid for the 18% and the newly revalued fair value of the 30%.

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 (a)(ii)). 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
Fair value of original 30% holding		127
Non-controlling interest at acquisition $(397.6 \times 52\%)$		206.8
Less net assets at acquisition:		
Net assets per question	348	
Fair value adjustment land	10	
Subsequent deferred tax	(2)	
Fair value adjustment inventory	47	
Subsequent deferred tax	(9.4)	
Database	5	
Subsequent deferred tax	(1)	(397.6)
Goodwill on acquisition of Grin Co		2.2

		Marking scheme	
(0)	/:\	Discussion of control (IFDC 10 and other feature) using the	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 – Calculation of investment in associate – Calculation of reserves	2 2 1
			5
	(iii)	Application of the following discussion to the scenario: – Acquisition of 18% equity – Share options	2 3
(b)	(i)	Discussion and calculation of the following FV adjustments – Land and DT – Inventory and DT – Customer list	2 3 3 8
	(ii)	Application of the following discussion to the scenario: - Piecemeal acquisition - Gain on step acquisition calculation - Impact on revaluation gain - Goodwill calculation	3 1 1 3 —
Total			30

Examiner's comments

Chuckle Co was a 30-mark question which translates (using 1.8 minutes per mark) into 54 minutes of the SBR exam. Candidates invariably spend too long on Q1 as it has more marks than any other question. However, there may be easier marks in other parts of the exam paper which are not achieved because of the excess time spent on Q1. The SBR exam states that all questions are compulsory and the consequences from not answering all questions are that it makes it much more difficult to pass the exam

a)i) Candidates generally could define significant influence as the ability to participate in the financial and operating policy decisions of the investee but not have control or joint control over these policies. In addition, many candidates expanded their answer to discuss control with the result that half marks (2 marks) were readily gained by many candidates. The difficulty came when candidates attempted to apply these principles to the scenario. Candidates needed to consider whether voting rights alone or whether a combination of factors was sufficient to obtain power. As Chuckle Co only held 30% of the equity and no additional voting rights, many candidates concluded that the correct classification was that of an associate. However, those candidates that concentrated on simply discussing why significant influence was demonstrated whilst ignoring why control was not indicated, did not perform as well on the question. Ensuring you have addressed all aspects of a requirement before moving on is important – candidates were directed to discuss 'as opposed to a subsidiary'.

a)ii) Many candidates explained that the initial investment is measured using equity accounting. However, candidates often could not apply the principle to the scenario. The application of the equity method of accounting is a basic requirement of the SBR exam and candidates could have scored at least half marks for its correct application in this question. It was surprising how many candidates did not provide a basic explanation of the equity method of accounting or make a reasonable attempt at the calculation.

The revaluation element was answered well by some and those that considered the treatment in the individual financial statements scored high marks. Several candidates incorrectly dealt with the revaluation via profit or loss. The treatment of revaluation gains and losses is again fundamental to this examination and is assumed knowledge. Candidates are losing relatively easy marks if they do not understand nor apply basic assumed knowledge of financial reporting principles. Candidates must be able to take advantage of the application of these basic principles as there are much more difficult areas of the SBR syllabus which candidates have to deal with.

a)iii) The acquisition of the extra 18% of the equity on 1 April 20X6 made Chuckle Co a significant minority investor as they now held 48% of the equity shares. Many candidates concentrated on the ownership of 48% and concluded that this was not enough to control and therefore, incorrectly concluded that the status should not change.

To gain a good mark, candidates not only needed to consider the purchase of the additional holding but also the potential voting rights. In this case, candidates should have observed that the share options were substantive and that exercising these options would enable Chuckle Co to obtain a 60% shareholding. Therefore, Chuckle Co is able to exercise power over the associate from 1 April 20X6. Thus, candidates should have concluded that the associate needs to be reclassified as a subsidiary at this date.

b)i) This requirement carried 8 marks and therefore a substantial answer was expected. As soon as fair value is mentioned in a requirement, the principles of IFRS 13 Fair Value Measurement should be used. This does not mean that definitions of level 1, 2 and 3 are required every time but it does mean that the relevant sections of the IFRS standard should be quoted in the answer.

Some candidates confused the fair value of finished goods with the net realisable value principle. Net realisable value refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business. Fair value reflects the price at which an orderly transaction to sell the same inventory in the principal or most advantageous market for that inventory would take place between market participants at the measurement date. The former is an entity-specific value, the latter is not. Net realisable value for inventories may not equal fair value less costs to sell. The fair valuation of finished goods created a further taxable temporary difference in the consolidated financial statements of Chuckle Co with a corresponding deferred tax liability at 20%.

As regards the database, many candidates realised that it would not be recognised in the individual financial statements of the subsidiary but would be recognised as a separate intangible asset from goodwill in the consolidated financial statements as the database appeared to be identifiable. Again, this valuation would result in a further increase in the deferred tax liability.

Candidates' knowledge of IFRS 13 was surprisingly limited. However, most candidates could apply the information given in the question and made a good attempt at calculating the fair values of the net assets acquired. A significant number of candidates did not consider the deferred tax implications, despite being specifically asked to, and as a result, could not gain full marks for the question.

b) ii) The discussion needed to include a brief description of the accounting treatment arising from the additional purchase of the 18% equity in the associate. The additional purchase of the 18% equity constituted a piecemeal or step acquisition which means that the previously held equity interest should be remeasured at its acquisition fair value with any resulting gain or loss going to profit or loss. Where the step acquisition was recognised by candidates, the accounting treatment was generally well documented. However, many candidates did not realise that the purchase of shares was a step acquisition.

The revaluation gain on land (net of deferred tax) would also be transferred from the revaluation surplus of the group to retained earnings on 1 April 20X6. Very few candidates mentioned this point.

The calculation of non-controlling interest (NCI) was dependent upon the correct calculation of the fair value of the net assets at acquisition and therefore the own figure rule was used to award marks on this part of the question. However, some candidates used incorrect NCI percentages. The NCI held 52% of the equity and this confused many candidates as they assumed that the NCI could not hold more than 50%. Many also failed to consider the deferred tax implications.

Overall, the calculation of goodwill was generally well answered. Answers on how to treat the additional purchase of 18% could have been improved as it was often too brief. Only the strongest candidates discussed the step acquisition and the fair value of the original consideration. Not many stated the gain would be recognised in profit or loss.

2



COLUMBIA (MAR/JUN 2021) Walk in the footsteps of a top tutor



Key answer tips

This question is a typical 'Q1' style question. It tests the groups syllabus area, but also includes requirements covering other syllabus areas – this time the topic areas tested is IAS 19 Employee Benefits.

The group content (seen in requirements (a) (i) & (ii)) consisted of discussion and explanation of group issues, not just group calculations. More marks are typically afforded to narrative elements of the answer than the calculation elements. Candidates should remember this when attempting answers - the focus should be on the explaination of the thought processes and rationales used when performing calculations, rather than just presenting an answer consisting solely of inexplicable calculations.

If you justify your point by applying reasonable assumptions but have calculated the figures incorrectly, credit will still be given for your rationale. If presented with only an incorrect calculation to mark, bereft of any justification as to how the numbers were derived, markers cannot awards any marks at all.

- (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.



To determine whether Columbia is the acquirer requires contemplation of who has control of Peru Co. This is a great illustration of the type of requirement where candidates should:

- (i) outline the rules from the standard (e.g. as above re control definition)
- (ii) apply the rules to the specific details in the questions (e.g. how does the particular arrangement illustrate control, which factors do not indicate control)
- (iii) provide a conclusion that addresses the requirement (e.g. based on the factors identifed do you think that Columbia is the acquirer or not?).

Throughout the proceeding paragraphs, you'll see reference to how the factors in the scenario illustrate 'power', the 'rights to variable returns' and 'the ability to affect the amount of variable returns'. The examiner is applying the rules from the standard to the specific scenario to allow a conclusion to be made.

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.



When discussing accounting issues, it is important to consider any possible alternative outcomes. In this requirement, you are asked to determine whether Columbia is the acquirer. Do not let any initial assumptions you make restrict your answer. As in, do not assume the examiner only wants to hear that Columbia is the acquirer. Confirmation bias can be displayed in many candidates answers, which can limit the marks awarded e.g. only mentioning the factors that suggest Columbia is the acquirer and ignoring any suggestions that Columbia may not be the acquirer.

Scenarios will regularly provide information that point towards different conclusions from what you may originally expect but which may (or may not) be able to be refuted when applying the rules of the standard. Here the answer addresses the potential for the acquisition of Peru Co to be a joint venture, rather than an acquired subsidiary which is fully controlled by Columbia (where Columbia would be the acquirer.

Some factors may confirm your hypothesis, others may indicate that alternative approaches may be relevant. Easy marks can be awarded by outlining why an accounting treatment is not relevant too (e.g. 'Peru Co is not a joint venture because...'.) A really good answer will be able to consider conflicting information and address whether it impacts on the candidate's overall conclusions.

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\% \times 5 million $\times 1/20 \times 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.



Tutorial note

Make sure you give a conclusion. Tell the examiner, based on the factors you identified in your explanation, whether you think Columbia is, or is not, the acquirer. Do not be afraid to have an opinion!

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

	\$m	\$m
Consideration		
– Cash (5m × 50% × \$8)		20
Shares ((5m × 50%)/20 × \$10)		1.25
		21.25
FV of NCI at acquisition (5m \times 50% \times \$8)		20
Less		
Fair value of net assets at acquisition		
Per question	32	
FV adjustment – bonds	2.16	
FV adjustment – brand	1	
FV adjustment – deferred income	0.59	
		(35.75)
Goodwill at acquisition		5.5



Tutorial note

The requirement asks for a calculation of goodwill. This should be a familiar calculation at this point. Therefore, set up a goodwill working template within the CBE software before reading the detail in the question. You can then fill in sections as you go through the detail rather than attempting the goodwill calculation all in one go (which can be inefficent from a timing perspective).

However, the question also asks for explanations of the fair values. The narrative is likely to carry a greater number of marks than the calculation.

IFRS 13 Fair Value Measurement states that the fair value 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. 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.



Tutorial note

The question requires explanations of the fair values used in a goodwill calculation. However, as well as discussing the relevant standards to help calculate goodwill (IFRS 3), other standards may be relevant too. To determine fair values, IFRS 13 Fair Value Measurement needs to be applied. It is easy to get pigeon-holed into only discussing one particular standard which can limit your discussion marks.

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 ($50\% \times 5$ million \times \$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 ($50\% \times 5$ million \times 1/20 \times \$10) for the share for share exchange.



Tutorial note

Discuss and explain the fair value of **both** the consideration paid (as above) and the various fair value adjustments required to determine the fair value of the net assets on acquisition (as below). The more issues you discuss, the more marks you can be awarded even if you make mistakes.

There are two main issues to identify in the consideration paid – the cash paid and the 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.



Some students get very confused about what measuring the non-controlling interest at fair value actually means. Keep it simple – we are trying to value the shares that the parent entity **did not** purchase.

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 \times $6 \text{ million} \times 8\%)$). 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.



Tutorial note

Remember, Goodwill is calculated at acquisition. As identified in the requirement, this is 1 July 20X5. Subsequent treatment of the financial asset at the year-end is irrelevant in this particular requirement so there is no need to discuss it.

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 \times 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).



There are three separate fair value adjustments to consider. The bond, the brand and the contract liability. Make sure you attempt to discuss them all as each one will have its own mark allocation. Marks can still be obtained even if you make a mistake but leaving an issue out entirely will definitely cost you credit. So, if you're not sure, have a guess and move on.

(b) Defined benefit plan

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 contributions to the plan (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\% \times 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:

	Asset	Liabilities	Net plan assets before ceiling adjustment	Ceiling adjustment	Net plan assets after ceiling adjustment
	\$m	\$m	\$m	\$m	\$m
Before 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 costs Curtailment and		30	(30)	-	(30)
settlement	(16)	(28)	12		12
Total at 31 December 20X5	253	187	66	(42)	24



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

An abbreviated version would directly use the 'Net plan assets after ceiling adjustment' column and still provide the conclusions shown below.

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).

Defined contribution plan

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.



Tutorial note

Do not neglect the much simpler defined contribution scheme. It is easy to take too long on the defined benefit scheme and miss out the defined contribution entirely. The defined contribution will definitely carry its own mark allocation. Maybe do it first!

		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
			10
Total			30

Examiner's comments

Overall this question was very well answered with some candidates scoring full marks.

Columbia Co was a 30-mark question. It is important to allow yourself time for reading, thinking and checking your answer within the allocated timeframe to ensure you have the opportunity to gain the maximum marks across the question. You should avoid the temptation to expand your answer to one requirement beyond the allotted time. For example, some candidates spent too long on Q1(a), meaning that they reached the maximum mark allocation well before the end of their answer. This meant they used time that should have been spent answering the remaining requirements, especially part (b). Markers cannot allocate more marks to a requirement than is available, even if the comments may otherwise be worthy of marks. So, in short, stick to your allotted time.

- a) (i) Many candidates cut and pasted information from the question. Marks were awarded as long as sensible comments were made by the candidates as to why the information was important in the determination of the acquirer the candidate **must add** their own comments to the cut and pasted information. There were many points that could be raised by candidates and the marking scheme flexibly allocated marks based upon the application of the control principle. As a result, many candidates scored full marks on this part of the question, demonstrating a good knowledge of the principles and their application.
- a) (ii) This part of the question attracted a significant number of marks (11 marks) and therefore there was an expectation of an in depth discussion of the principles of fair values and their application. The calculation of goodwill was well answered but it seldom attracts more than 2/3 marks as generally the calculation is relatively straightforward.

Candidates answered this part of the question satisfactorily. Consideration was usually calculated correctly as was the non-controlling interest. However, various errors were made when trying to correctly account for the fair values of identifiable net assets. Many candidates struggled with the fair valuation of the bond, although the concept of fair values was generally well understood.

Dealing with the accounting for the brand was the best answered part of the question, although a common mistake was to use the full fair value rather than the fair value adjustment when calculating goodwill.

b) Candidates showed a good knowledge an understanding of both defined benefit and defined contribution schemes and were able to make a good attempt at the calculations, although the discussion was lacking at times. The defined contribution element was well answered.

3



SUGAR (SEP/DEC 2020) Walk in the footsteps of a top tutor



Key answer tips

This question tests consolidated statements of cash flow. This is a topic that students find difficult. However, in part (b), there are lots of easy marks for simply picking up figures from the scenario. Read the question carefully so that you are able to identify these easy marks.

Pay careful attention to verbs. Part (a) asks for you to 'address' the accounting treatment. Part (b) requires you to 'prepare extracts'. This means that explanations will score you marks in part (a), but will not in part (b).

Parts (a) and (b) involve calculations. Set out workings clearly – this will help the markers give you credit even if you have made mistakes.

(a) Cash paid to acquire Flour Co

The acquisition of Flour Co is a step acquisition. This means the original 40% equity interest is treated as if it is disposed and then reacquired at fair value. The difference between the carrying amount of the original 40% equity interest in the consolidated financial statements and its fair value would be included as a gain within profit or loss.



Tutorial note

Gains and losses arising on step acquisitions are recorded in profit or loss unless the previous shareholding was an investment in shares that had been designated to be measured at fair value through other comprehensive income.

As an associate, the investment would have been accounted for using the equity method and would be carried at \$14.8 million as at 1 July 20X7:

	\$000
Cost	10,000
Share of post-acquisition net asset increase (\$12m × 40%)	4,800
Investment in associate as at 1 July 20X7	14,800



Tutorial note

Any associate impairments would have been deducted from the carrying amount of the investment.

The fair value of the original 40% interest would be \$15.2 million ($10m \times 40\% \times 3.80) and so gain of \$400,000 (\$15.2m - \$14.8m) would be included in profit or loss.



Tutorial note

Goodwill is always calculated on the date control is achieved. It is not recalculated, even if the parent increases its shareholding.

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



Tutorial note

Some students get very confused about what measuring the non-controlling interest at fair value actually means. Keep it simple – we are trying to value the shares that the parent entity **did not** purchase.

The fair value of the non-controlling interest at 1 July 20X7 will be \$11.4 million (10m \times 30% \times \$3.80). The fair value of the share exchange will be \$9 million. (3 million shares acquired \times ½ \times \$6).



Put all the relevant figures into the goodwill calculation. Remember that the subsidiary's identifiable net assets at acquisition are measured at fair value. The 'cash consideration' is the balancing figure.

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

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



Tutorial note

The share exchange is not a cash flow and so will not be reported in the statement of cash flows.

The debit entry for the share exchange is recorded in goodwill. The credit entry is recorded in equity (share capital and premium).

Cash paid to acquire Flour Co will be included within the investing activities of the consolidated statement of cash flows. However, the cash held by Flour Co comes under group control, so the net outflow presented in the consolidated statement of cash flows is \$1,766,000 (\$3m - \$1.234m).

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



Tutorial note

Remember to put brackets around the cash outflows. Try and reference figures to your workings – this will help the marker award credit if you have made a mistake.

Cash flows from investing activities

	\$000
Net cash paid on acquisition of Flour Co (part a)	(1,766)
Cash paid to acquire intangible assets (W1)	(12,051)
Proceeds from disposal of property plant and equipment (W2)	4,370
Cash paid on acquisition of Butter Co	(5,000)
Dividends received from associates (W3)	2,253
Proceeds from disposal of FVTPL investment (\$4m + \$0.5m)	4,500
Investment income received (W5)	1,991
Cash flows from financing activities	
	\$000
Issue of ordinary shares during the year (W6)	9,600
Dividends paid to the non-controlling interest (W7)	(3,324)

Workings



Tutorial note

Set out your workings clearly. This will help you to score marks even if you make mistakes.

(W1) Intangibles



Tutorial note

Remember to include the intangible assets owned by Sugar Co. These are now under group control.

	\$000
Intangibles b/f	15,865
Goodwill on acquisition of Sugar Co	2,259
Licences and patents on acquisition of Sugar Co	6,781
Amortisation	(3,500)
Cash purchase (bal. fig.)	12,051
Intangibles c/f	33,456

(W2) Property, plant and equipment

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

The asset was sold at a loss of \$2\$ million, so disposal proceeds must have been \$4.37\$ million (\$6.37m - \$2m).

(W3) Dividends received from associates



Tutorial note

As a result of the step acquisition, Sugar Co is a subsidiary rather than an associate. As such, the investment in the associate must be derecognised.

When accounting using the equity method, dividends received are deducted from the carrying amount of the investment.

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

(W4) FVTPL financial asset



Tutorial note

This working will enable you to work out the gain arising on remeasurement of these assets to fair value. This gain has been reported in investment income, but it is not a cash flow. When working out cash from investments (W5), you will need to remove this gain from investment income.

	\$000
FVTPL asset b/f	6,000
Carrying amount of disposal	(4,000)
Fair value gains (bal. fig.)	1,000
FVTPL asset c/f	3,000

(W5) Investment income



Tutorial note

This is probably the trickiest working. The investment income line in the statement of profit or loss includes lots of non-cash income. These need to be removed in order to calculate the cash received from investments.

	\$000
Investment income per PL	3,891
FV gains on FVTPL investments (W4)	(1,000)
Fair value gains on step acquisition (part (a))	(400)
Profit on disposal of FVTPL	(500)
Investment income received	1,991

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

(W6) Issue of ordinary shares during the year



Tutorial note

Remember to reconcile the total of share capital and premium year-on-year. Lots of students will forget about the impact of the share exchange in part (a).

	\$000
Share capital and premium b/f (\$20m + \$18m)	38,000
Share for share exchange (part a)	9,000
Cash proceeds (bal. fig.)	9,600
Share capital and premium c/f (\$23m + \$33.6m)	56,600

(W7) Dividends paid to non-controlling interest



Tutorial note

Many students struggle with this working. If you find it tricky then try and memorise the items that are included.

	\$000
Non-controlling interest b/f	12,914
Acquisition of Flour Co (part a)	11,400
Non-controlling interest profit for the year	9,162
Dividends paid to non-controlling interest (bal. fig.)	(3,324)
Non-controlling interest c/f	30,152

(c) Defined benefit scheme



Tutorial note

To answer this question, you need to nail down the accounting treatment of a defined benefit pension scheme. Once you have done that, you should be able to identify the cash flow and the non-cash expenses.

The only cash flow that should be recorded in the consolidated statement of cash flows in relation to defined benefit pension schemes is the contributions paid into the scheme. This is typically included within the operating activities of the group statement of cash flows.

Since Sugar Co did not make any contributions until after the year-end there will be no cash flows to include in the consolidated statement of cash flows for the year ended 30 June 20X8. The \$2 million benefits paid out of the scheme are an outflow of cash from the pension scheme itself, a separate entity, rather than a cash outflow of Sugar Co.

This does not mean that the pension scheme will not have any impact upon the consolidated statement of cash flows of the Sugar group. Since operating activities are being calculated using the indirect method it is necessary to adjust for any items that effect operating profit but are not cash flows. The service cost component would need to be added back to group profits. Finance costs in profit and loss would include the net interest component – this is not a cash flow and so would require adjusting.

The remeasurement component does not impact the group statement of cash flows since it is not a cash flow, nor does it impact operating profit.



The remeasurement component is reported in other comprehensive income. It is presented as an item that will never be reclassified to profit or loss.

In SBR exam questions, the remeasurement component is normally accumulated in other components of equity. However, the question states that other components of equity wholly relate to share premium. This must mean that the remeasurement component has been accumulated in retained earnings. Per IAS 1 Presentation of Financial Statements, this treatment is allowed and is, in fact, the treatment adopted by many real-life companies.

	ACCA marking guide	
		Marks
(a)	Application of the following discussion to the scenario:	
	 Treatment as an associate including FV 40% and share exchange at 1 July 20X7 	5
	 FV NCI and identifiable net assets at 1 July 20X7 	3
	 Goodwill calculation and treatment of cash consideration 	2
		10
(b)	Marks for calculations as follows:	
. ,	Acquisition of Intangibles	3
	Proceeds on disposal of PPE	3
	Cash paid for Butter Co	1
	Dividends received from associates	2
	Investment income received	3
	Issue of ordinary shares	2
	Non-controlling interest dividend	2
		16
(c)	Application of the following discussion to the scenario:	
. ,	- Cash flows to include/exclude	2
	Other elements of defined benefit scheme	2
		4
Total		30
· Jui		

Examiner's comments

Overall, part (a) was well-answered. Most candidates provided clear explanations, and a significant number of answers calculated the correct cash consideration. Many answers explained where the cash outflow would appear in the statement of cash flows, although very few worked out the net outflow.

Part (b) required collating information from various sources, and there was evidence from some candidates' answers that they found this challenging. A well-presented answer would include a list of additions or deductions leading from opening to closing balances, with a balancing item for the cash item. Some spreadsheet answers did not use the functionality available which meant basic arithmetic errors occurred. Similarly, some candidates did not show the workings behind a figure – this could have been presented as a typed out working or as formula within a cell. Not showing any supporting workings means it is not possible to award partial marks.

For part (c), weaker answers tended to focus too much on the benefits paid in the next year, which was not relevant for answering the question on cash flow impact. Some candidates incorrectly suggested this represented an adjusting event and missed the cash flow focus of the requirement.

4



HUMMINGS (MAR 2020) Walk in the footsteps of a top tutor



Key answer tips

Only 14 of the 30 available marks in this question test group accounting. In fact, the requirement worth the most marks tests financial instruments. There is no point attempting to guess which topics will be examined in your SBR exam - instead, you must cover, and feel comfortable with, the whole syllabus. Although this question tests many different accounting standards, well-prepared students should not find it too tough.

The easiest marks are on the topic of foreign exchange – 5 marks in part (a) for a discussion of functional currency and 6 marks in part (b) on accounting for goodwill. Concentrate on these if you are struggling.

(a) **Functional currency**



Tutorial note

Start by stating the definition of functional currency and the principles used to determine it.

Remember that a subsidiary would have the same functional currency as its parent if it acted with little autonomy.

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



Make sure that you reach an explicit conclusion – what is the functional currency of Crotchet Co?

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

(b) (i) Customer contracts



Tutorial note

This question is only worth 4 marks so your answer should be less detailed than the one below, otherwise you would be wasting time.

You score easy marks for stating the key principles – the subsidiary's identifiable net assets at acquisition are recognised at fair value.

IFRS 3 *Business Combinations* requires the investor to recognise the investee's identifiable net assets at acquisition at fair value.

To be identifiable, a customer contract must either be capable of being used or sold separately, or it must arise from legal or contractual rights. A reliable estimate of its fair value is also necessary to be recognised as a separate asset rather than subsumed within the goodwill figure. This is the case regardless of whether the contracts had been recognised within the individual financial statements of Crotchet Co or not.

The contracts provide Crotchet Co with a legal right to prevent their customers from obtaining goods and services from their competitors and a reliable estimate of fair value appears to be obtainable. The contracts should therefore be recognised as a separate intangible asset.

Identifiable net assets should be recognised at fair value as at the acquisition date. For the contracts, this amounts to 15 million grommits. This would be translated at the spot rate of exchange of \$1 to 8 grommits and would be recognised initially in the consolidated financial statements at \$1.875 million.



The question asks for the accounting treatment in the year ended 31 December 20X4. As such, you should discuss the accounting treatment subsequent to initial recognition – i.e. amortisation. Many students concentrate on initial recognition issues only.

The contracts need to be examined to determine their average unexpired useful life and amortised over this period. This amortisation expense should be translated at the average rate of exchange and recorded in consolidated profit or loss. The carrying amount of the contracts would need to be retranslated at the closing rate of exchange of \$1 to 7 grommits, with a corresponding exchange gain recognised in other comprehensive income.

(ii) Calculation of goodwill



Tutorial note

Set out your workings neatly.

You will only be penalised for errors once, so do not worry if you make a mistake early in the calculation (such as with the net assets figure).

In SBR, goodwill impairments are normally translated at the average rate of exchange. However, this rate was not provided and so the closing rate was used instead.

Goodwill at 31 December 20X4 would be \$8.2 million calculated as follows:

	Grommits millions	Rate	\$ millions
Consideration (\$24m × 8)	192		
NCI at acquisition ($$6m \times 8$)	48		
Net assets at acquisition (W1)	(158)		
Goodwill at 1 January 20X4	82	8	10.25
Impairment (30%)	(24.6)	7	(3.51)
Exchange gain (bal. fig.)			1.46
Goodwill at 31 December 20X4	57.4	7	8.2

(W1) Net assets at acquisition

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

Explanation of accounting treatment



Tutorial note

Be explicit about **where** income and expenses are recognised – the statement of profit or loss, or in other comprehensive income.

Many students forget to discuss whether income or expenses should be attributed to non-controlling interests.

Goodwill is initially recognised at the spot rate of exchange of \$1:8 grommits and so would initially be \$10.25 million.

The impairment loss of \$3.51 million will be expensed to the consolidated statement of profit or loss.

Goodwill will be retranslated using the closing rate of exchange of \$1:7 grommits with the exchange gain of \$1.46 million included in other comprehensive income.

Since non-controlling interests at acquisition are measured at fair value, both the impairment and the exchange gain will be apportioned 80/20 between the shareholders of Hummings Co and the non-controlling interest respectively.

(c) Quaver Co



Tutorial note

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations is regularly tested in the SBR exam. Make sure that you know the definition of an asset held for sale, as well as the qualifying criteria. Applying these criteria to the scenario is relatively straightforward.

An asset or disposal group should be classified as held for sale if the carrying amount will be primarily recovered through a sales transaction. For this to be the case, IFRS 5 Non-current Assets Held for Sale and Discontinued Operations states that:

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

The sale has not taken place within 12 months of acquisition; however, an exception is permitted where the sale is still deemed to be highly probable and the delay was caused by events which were unforeseen and beyond the control of management. The sale is still expected early in 20X5 and the legal dispute was unforeseen, so this exception seems applicable. As such, Quaver should be classified as a disposal group held for sale. Quaver Co should initially be measured at fair value less costs to sell with any subsequent decreases in fair value less costs to sell taken to consolidated profit or loss.

It appears clear that management was immediately committed to the sale as Hummings Co did not wish to have active involvement in the activities of Quaver Co. Quaver Co is therefore a subsidiary acquired exclusively with a view to resale. In accordance with IFRS 5, Quaver should be presented as a discontinued operation and so its earnings for the year must be disclosed separately in the consolidated statement of profit or loss.



Tutorial note

Students are generally good at spotting issues about assets held for sale, but tend to omit discussion of discontinued operations. Remember that disposing of (or holding for sale) a separate major line of business, or the operations within a specific geographical area, would also qualify as a discontinued operation.

(d) Year ended 31 December 20X3



Tutorial note

The question asks you to consider the accounting treatment as at 31 December 20X3 and for the year ended 31 December 20X4.

Make sure that you discuss the accounting treatment of the bond itself, as well as the impairment rules.

The business model of Hummings Co is to collect the contractual cash flows of the bonds over the life of the asset, so the bonds should be measured at amortised cost.

The financial asset should be recognised at fair value (plus fees if applicable), which is equal to the \$10,000,000 paid to purchase the bonds.



Tutorial note

State the relevant principles in IFRS 9 Financial Instruments with respect to financial asset impairments before applying them to the scenario.

IFRS 9 *Financial Instruments* requires entities to calculate expected credit losses for investments in debt instruments that are measured at amortised cost or fair value through other comprehensive income.

On acquisition, the bonds are low risk and are not credit impaired. This means that Hummings Co should calculate 12-month expected credit losses. The 12-month expected credit loss is defined as a portion of the lifetime expected credit losses which represent the expected credit losses resulting from a default within the next 12 months.

Hummings Co should therefore recognise an allowance of \$10,000 as at 31 December 20X3. This will be expensed to profit or loss and a separate allowance created. The allowance is netted off the \$10,000,000 bond in the statement of financial position of Hummings Co as at 31 December 20X3. The carrying amount of the bonds in the statement of financial position at 31 December 20X3 will be \$9.99\$ million \$10,000.

Year ended 31 December 20X4

Interest income at the effective rate of 8% should be recognised in profit or loss and added to the carrying amount of the financial asset. This is calculated on the gross carrying amount of the financial asset (\$10m\$) and amounts to \$800,000 ($$10m \times 8\%$).

The coupon interest of \$500,000 ($$10m \times 5\%$) is deducted from the carrying amount of the bonds. This means that the bonds would have a carrying amount of \$10,300,000 (\$10m + \$0.8m - \$0.5m) at 31 December 20X4 before considering any impairment issues.



Tutorial note

Discuss the principles regarding the measurement of the loss allowance before you calculate it.

At 31 December 20X4, there has been a significant increase in credit risk. This means that Hummings Co should make an allowance to recognise the lifetime expected credit losses. This is defined as the expected credit losses (cash shortfalls) which result from all possible default events over the expected life of the bonds. An allowance is required equal to the present value of the expected loss in contractual cash flows as weighted by the probability of default. The expected default losses are discounted using the original effective rate of interest of 8%.

Date	Cash flow working	PV of default (\$)
31/12/X5	3% × \$462,963	13,889
31/12/X6	5% × \$6,858,710	342,936
		356,825



Don't stop with the calculation of the loss allowance; discuss how it is accounted for.

The expected loss allowance should be increased to \$356,825 with an expense recorded in profit or loss of \$346,825 (\$356,825 - \$10,000). The net carrying amount of the bonds reported in the statement of financial position as at 31 December 20X4 would be \$9,943,175 (\$10,300,000 - \$356,825).

		Marking scheme	
			Marks
(a)		Autonomy from parent	2
		Determination of functional currency	3
			_5
(b)	(i)	Identifiable criteria and recognition	3
		Need to amortise	1
			4
	(ii)	Goodwill calculation	4
		Discussion of impairment and exchange	1
		Recognition of split between shareholders	1
			6
(c)		Discussion of asset held for sale criteria	2
		Application of above to Quaver Co	2
			4
(d)		Amortised cost identification	1
		12 month credit loss discussion	2
		12 month credit loss calculation	1
		Amortised cost calculation	1
		Explanation of lifetime credit losses	3
		Calculation of lifetime credit losses	3
			11
Total			30

Examiner's comments

Answers to part (a) were generally good, with most candidates displaying a good application of primary economic environment principles by which the functional currency is determined, leading to a valid conclusion.

In part (b) (i), weaker answers expanded beyond the requirement, to include general consolidation techniques, or erroneously focused on IFRS 15 *Revenue from Contracts with Customers* rather than IFRS 3 *Business Combinations*. In part (b) (ii), the calculation at the acquisition date was generally well-answered, provided candidates followed the guidance: calculating goodwill first at local currency, including a fair value adjustment highlighted in part (b) (i), and then translating. Fewer candidates achieved full marks as they neglected to explain the impact of both impairment and exchange difference on the consolidated financial statements.

Answers to part (c) in general showed a good appreciation of the rules and applied these to the scenario. Most candidates were able to score well from applying their knowledge.

Part (d) had the most marks allocated to it but was often the shortest answer compared to the other parts. Few candidates demonstrated a clear understanding of the expected value approach to impairment losses under IFRS 9 Financial Instruments, and a general lack of confidence in this area is evident. The second year treatment was less-well explained, with very few candidates calculating the appropriate probability-weighted allowance. The net increase in this allowance was rarely presented. Explanations tended to be too brief or, if provided, were not applicable to the scenario. The focus tended to be on calculations despite the requirement explicitly asking for "calculation and discussion". Weaker answers presented a table of discounted cashflows, or recommended treatment at fair value through profit or loss, which illustrated a lack of preparation in this area.

5



LUPLOID (SEP/DEC 2019) Walk in the footsteps of a top tutor



Key answer tips

Question 1 always examines group accounting, but other issues will be tested as well. This question requires a good knowledge of IFRS 13 Fair Value Measurement, IAS 36 Impairment of Assets and IFRS 2 Share-based Payment.

Part (b) is worth 11 marks. To score well your answer must contain more than just a series of calculations. Explain how the impairment review is performed, which assets are written down, and where the impairment loss is recorded.

(i) Fair value measurement (a)



Tutorial note

Fair value measurement is a popular exam topic. Make sure that you know the definition of fair value.

IFRS 13 Fair Value Measurement defines fair value as 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. Fair value is therefore not supposed to be entity specific but rather market focused. Essentially the estimate is the amount that the market would be prepared to pay for the asset.



The fair value of a non-financial asset should be determined based on its highest and best use. Non-financial assets include property, plant and equipment, inventories, intangible assets, and investment properties.

The market would consider all alternative uses for the assessment of the price which they would be willing to pay. For non-financial assets, fair value should therefore be measured by consideration of the highest and best use of the asset. There is a presumption that the current use would be the highest and best use unless evidence exists to the contrary.

The highest and best use of the asset appears to be as residential property and not the current industrial use. The intentions of Colyson Co are not relevant as fair value is not entity specific. The alternative use would need to be based upon fair and reasonable assumptions. In particular, it would be necessary to ensure that planning permission to demolish the factory and convert into residential properties would be likely. Since several nearby sites have been given such permission, this would appear to be the case.

The fair value of the factory site should be valued as if converted into residential use. Since this cannot be determined on a stand-alone basis, the combined value of the land and buildings is calculated. The \$1 million demolition and planning costs should be deducted from the market value of \$24 million. The fair value of the land and buildings should be \$23 million. The fair value of the identifiable net assets at acquisition are \$88 million (\$65m + \$23m).

Depreciated replacement cost

Depreciated replacement cost should only be considered as a possible method for estimating the fair value of the asset when other more suitable methods are not available. This may be the case when the asset is highly specialised. This is not the case with the factory site. Depreciation is unlikely to be an accurate reflection of all forms of obsolescence including physical deterioration. Moreover, the rise in value of land and properties particularly for residential use would mean that to use depreciated replacement cost would most likely undervalue the asset.

(ii) Goodwill calculations



Tutorial note

This part of the question only asked for 'calculations'. No marks are awarded for discussion of the goodwill calculations.

Goodwill should be calculated as follows:

	Fair value method	Proportional method
	\$m	\$m
Consideration	90	90
Non-controlling interest (NCI) at acquisition	22	17.6
Net assets at acquisition	(88)	(88)
Goodwill	24	19.6

NCI at acquisition under proportional method is \$17.6m (20% × \$88m).

The fair value of the net assets at acquisition is \$88m as per part (a) (i) (\$65m + \$23m).

(b) Impairment

An impairment arises where the carrying amount of the net assets exceeds the recoverable amount.

Where the cash flows cannot be independently determined for individual assets, they should be assessed as a cash generating unit. That is the smallest group of assets which independently generate cash flows. Impairments of cash generating units are allocated first to goodwill and then to the other assets in proportion to their carrying amounts. No asset should be reduced below its recoverable amount.

Fair value method

The overall impairment of Colyson Co is \$30 million (\$106m + goodwill \$24m - \$100m).

The damaged building should be impaired by \$4 million with a corresponding charge to profit or loss. Since \$4 million has already been allocated to the land and buildings, \$26 million of impairment loss remains to be allocated.

The full \$24 million of goodwill should be written off and expensed in the consolidated statement of profit or loss.

Of the remaining \$2 million impairment (\$30m - \$4m - \$24m), \$1.25 million will be allocated to the plant and machinery ($(15/(15 + 9)) \times 2m$) and \$0.75 million will be allocated to the remaining intangibles ($(9/(9 + 15)) \times 2m$). As no assets have been previously revalued, all the impairments are charged to profit or loss.



Tutorial note

If the NCI has been measured at fair value at acquisition then 'full goodwill' has been calculated (i.e. the goodwill attributable to the owners of the parent company and the goodwill attributable to the NCI). As such, the NCI must be attributed its share of the goodwill impairment charge.

Of the impairment loss, \$24 million ($80\% \times 30 m) will be attributable to the owners of Luploid Co and \$6 million ($20\% \times 30 m) to the NCI in the consolidated statement of profit or loss.

The allocation of the impairment is summarised in this table:

	Original CA	Impairment	Revised CA
	\$m	\$m	\$m
Land and buildings	60	(4.00)	56
Plant and machinery	15	(1.25)	13.75
Intangibles other than goodwill	9	(0.75)	8.25
Goodwill	24	(24.00)	0
Current assets (at recoverable amount)	22	-	22
			
Total	130	(30)	100

Proportionate method

The basic principles and rule for impairment is the same as the fair value method and so \$4 million will again first be written off against the land and buildings.

When NCI is measured using the proportional share of net assets, no goodwill attributable to the NCI is recognised. This means that the goodwill needs to be grossed up when an impairment review is performed so that it is comparable with the recoverable amount.

The goodwill of \$19.6 million is grossed up by 100/80 to a value of \$24.5 million. This extra \$4.9 million is known as notional goodwill. The overall impairment is now \$30.5 million (\$106m + \$24.5m - \$100m) of which \$4 million has already been allocated to land and buildings.

Since the remaining impairment of \$26.5 million (\$30.5m - \$4m) exceeds the total notional goodwill, this is written down to zero. However, as only \$19.6 million goodwill is recognised within the consolidated accounts, the impairment attributable to the notional goodwill is not recognised. The impairment charged in the consolidated statement of profit or loss is therefore \$19.6 million and this is fully attributable to the owners of Luploid Co.

Of the remaining \$2 million (\$30.5m - \$4m - \$24.5m), \$1.25 million will be allocated to the plant and machinery ($15/(15 + 9) \times 2m$) and \$0.75 million will be allocated to the remaining intangibles ($9/(9 + 15) \times 2m$). As no assets have been previously revalued, all the impairments are charged to profit or loss.



Tutorial note

If goodwill is calculated using the proportionate method, then the goodwill impairment recognised in the consolidated financial statements is all attributable to the owners of the parent company. However, any impairment loss related to other assets must be allocated between the owners of the parent company and the non-controlling interest.

The impairment expense attributable to the owners of Luploid Co is \$24.4 million (\$19.6m goodwill impairment + ($80\% \times ($4m building + $2m plant and machinery and other intangibles))). The impairment expense attributable to the NCI is $1.2 million (<math>20\% \times $6m$). This is summarised below:

	Original CA	Impairment	Revised CA
	\$m	\$m	\$m
Land and buildings	60	(4.00)	56
Plant and machinery	15	(1.25)	13.75
Intangibles other than goodwill	9	(0.75)	8.25
Goodwill	19.6	(19.60)	0
(Notional goodwill)	4.9	(4.90)	0
Current assets (at recoverable amount)	22	_	22
Total	130.5	(30.5)	100

(c) (i) Consideration

IFRS 3 *Business Combinations* requires all consideration to be measured at fair value on acquisition of a subsidiary.

Deferred shares should be measured at the fair value at the acquisition date with subsequent changes in fair value ignored. Luploid Co will issue 2.4 million $(60\% \times 10m \times 2/5)$ shares as consideration. The market price at the date of acquisition was \$30, so the total fair value is \$72 million (2.4m × \$30).

Since Luploid Co is obliged to replace the share-based scheme of Hammond Co on acquisition, the replacement scheme should also be included as consideration (but only up to the fair value of the original scheme as at 1 July 20X7). The fair value of the replacement scheme at the grant date was \$18 million. However the fair value of the original Hammond Co scheme at the acquisition date was only \$15 million. As such, only \$15 million should be added to the consideration.

The total consideration should be valued as \$87 million (\$72m + \$15m).

(ii) Expense related to replacement scheme

The \$3 million (\$18m - \$15m) not included within the consideration (see above) should be treated as part of the post-acquisition remuneration package for the employees and measured in accordance with IFRS 2 *Share-based Payment*. As there are no further vesting conditions it should be recognised as a post-acquisition expense immediately.

Expense related to additional scheme



Tutorial note

When dealing share-based payment questions, students tend to provide answers that are wholly numerical. Make sure that you discuss and apply the principles from IFRS 2 Share-based Payments or you will miss out on some very easy marks.

The condition relating to the share price of Luploid Co is a market based vesting condition. These are adjusted for in the calculation of the fair value at the grant date of the option. An expense is therefore recorded in the consolidated profit or loss of Luploid Co (and a corresponding credit to equity) irrespective of whether the market based vesting condition is met or not.

The additional two years' service is a non-market based vesting condition. The expense and credit to equity should be adjusted over the vesting period as expectations change regarding the non-market based vesting condition.

The correct charge to the profit or loss and credit to equity in the year ended 30 June 20X8 is \$9.6 million $((10,000 \times 96\%) \times 100 \times \$20 \times \%)$.

	ACCA marking guide	
		Marks
(a)	(i) – application of the following discussion to the scenario:	
	how FV should be determined	5
	why depreciation replacement cost is unsuitable	2
		7
	(ii) – calculation marks for:	
	correct FV of net assets	1
	correct NCI figures	2
	correct North Bures	
		3
(b)	– discussion of what constitutes an impairment and CGUs	2
(-)	– correct calculation of impairment losses for both methods	2
	– notional goodwill	1
	– impairment allocation	3
	– discussion of how and why methods differ	3
	,	
		11
(c)	(i) — calculation FV of deferred shares	1
(-)	– calculation of FV of options	1
	 discussion of the above calculations and application to the scenario 	2
		4
	(ii)	
	(ii) — calculation share expense	1
	 application of the following discussion to the scenario: Calculations 	,
		2 2
	vesting conditions	2
		5
Total		30

Examiner's comments

Answers to part (a) (i) were generally good, with most candidates outlining the methods by which fair value is determined under IFRS 13. 11 marks were available for part (b) and most answers allocated an appropriate amount of their answer to this part. Whilst almost all answers described the basic impairment process, a surprising number of candidates excluded goodwill from their impairment calculation. This may have limited their opportunities for marks, particularly where their explanations did not explain the process by which an impairment loss is allocated to assets of a cash generating unit. Very few candidates explained the need for grossing-up goodwill under the net assets NCI valuation method, and how this is then allocated between group and NCI. Explanations of how the impairment loss is apportioned between group and NCI were generally quite basic. Indeed, most candidates identified that there is no goodwill attributable to NCI under the proportion of net assets valuation, but then suggested none of the impairment need be apportioned to NCI).

Part (c) (i) required an explanation of how consideration in the form of shares in a second acquisition should be valued. Most answers correctly calculated the fair value of the share exchange. Part (c) (ii) asked for the resulting share-based expense and a discussion of the vesting conditions; unfortunately this was less-well answered.

6



CARBISE (MAR/JUN 2019) Walk in the footsteps of a top tutor



Key answer tips

This question examines the topic of overseas subsidiaries. As should be expected, the question requires the calculation of key figures in the consolidated financial statements (such as goodwill and foreign exchange differences), but also explanations of the accounting principles behind those calculations.

(a) Subject: Foreign subsidiary Bikelite

(i) Presentation currency



Tutorial note

Start off with the definition of presentation currency.

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

Functional currency



Tutorial note

Start off with the definition of functional currency.

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



Tutorial note

Remember that a subsidiary is likely to have the same functional currency as its parent if certain factors apply – such as if the subsidiary operates with little autonomy from its parent.

When determining the functional currency of Bikelite, consideration should first be given to whether the functional currency of Bikelite should be the same as Carbise, at least whilst under the control of Carbise.

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



Tutorial note

State the primary factors used to determine functional currency and then apply them to the scenario.

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



Tutorial note

If the primary factors used to determine functional currency are inconclusive then an entity must apply secondary factors.

Secondary factors include the currency in which financing activities are obtained and the currency in which receipts from operating activities are retained. Funds were raised in dinars from the bond issue and so it would appear that the dinar should probably be the functional currency for Bikelite.

(ii) Goodwill



Tutorial note

Be careful – the acquisition of the subsidiary was not in the current year. The question asks you for the current year foreign exchange gain on goodwill, not the cumulative gain.

Goodwill in dinars on the acquisition of Bikelite would be dinar 42 million. This is calculated as follows:

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

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

An impairment of dinars 6 million arose in the year ended 31 December 20X5.



Tutorial note

This would have been translated at the average rate in the prior reporting period. The impairment charge of \$15 million (dinar 6m/0.4) would have been recorded in the statement of profit or loss in the prior period.

The remaining goodwill of dinars 36 million (dinars 42m - dinars 6m) would have been translated as at 31 December 20X5 using the closing rate of \$1:0.38. Goodwill in the consolidated statement of financial position as at 31 December 20X5 would have been \$94.7 million (dinars 36m/0.38).

Goodwill of dinar 36 million at 30 September 20X6 will be translated at the rate on that date of \$1:0.35. This amounts to \$102.9 million (dinars 36m/0.35).

This is summarised below:

	Dinar millions	rate	\$ millions
Goodwill at 31 December 20X5	36	0.38	94.7
(dinar 42m – dinar 6m)			
Exchange gain (bal. fig.)			8.2
Goodwill at 30 September 20X6	36	0.35	102.9

The exchange gain arising in the current year is therefore \$8.2 million (\$102.9m - \$94.7m).

(iii) Explanation of goodwill calculation and exchange gain



Tutorial note

You need to briefly explain how to calculate goodwill **and** the treatment of the foreign exchange differences arising on its retranslation. Make sure you identify all the requirements or you will lose easy marks.

On a business combination, goodwill is calculated by comparing the fair value of the consideration plus non-controlling interests (NCI) at acquisition with the fair value of the identifiable net assets at acquisition.

An adjustment of dinar 20 million is required to the property of Bikelite to ensure the net assets at acquisition are properly measured at fair value.

Carbise measures NCI using the fair value method. This means that goodwill attributable to the NCI is included within the overall calculation of goodwill.

At each year end, all assets (including goodwill) and liabilities are retranslated using the closing rate of exchange. Exchange differences arising on the retranslation are recorded within other comprehensive income. Since the non-controlling interest is measured under the fair value method, the exchange difference would be apportioned 80%/20% between the owners of Carbise and the non-controlling interest.



Tutorial note

If the non-controlling interest had been valued at its proportionate share of the fair value of the subsidiary's identifiable net assets, then the foreign exchange gain on goodwill would have been wholly attributable to the owners of Cabrise.

Only the current year exchange difference would be recorded within other comprehensive income for the year ended 31 December 20X6. The cumulative exchange differences on goodwill at 30 September 20X6 (i.e. the exchange gain in the prior and current period) would be held in equity prior to the disposal of Bikelite.

(b) Exchange differences on net assets and profit



Tutorial note

Easy marks are available for explaining **why** foreign exchange differences arise.

The net assets of Bikelite would have been retranslated each year at the closing rate of exchange. There is therefore an exchange difference arising each year by comparing the opening net assets at the opening rate of exchange with the opening net assets at the closing rate of exchange.

An additional exchange difference arises through the profit or loss of Bikelite each year being translated at the average rate of exchange in the consolidated statement of comprehensive income. The profit or loss will increase or decrease the net assets of Bikelite respectively which, as is indicated above, will be translated at the closing rate of exchange for inclusion in the consolidated statement of financial position.

As with goodwill, the current year exchange differences are presented in other comprehensive income with 80% attributable to the shareholders of Carbise and 20% to the NCI. Cumulative exchange differences will be included in equity on the consolidated statement of financial position.



Tutorial note

The figures from the separate financial statements of Bikelite will not include any consolidation adjustments.

The carrying amount of the net assets of Bikelite in the separate financial statements on 1 January 20X6 was dinar 48 million. This would not include the dinar 20 million fair value adjustment, or subsequent depreciation arising on this. The carrying amount of Bikelite's opening net assets in the consolidated financial statements would therefore be dinar 64 million (dinar $48 + (dinar 20 million \times 16/20)$).

Bikelite would only be consolidated for the first nine months of the year because Carbise loses control on 30 September 20X6. Losses per the separate financial statements for the year ended 31 December 20X6 were dinar 8 million, so only dinar 6 million would be consolidated. Additional depreciation of dinar 0.75 million (dinar $20\text{m}/20 \times 9/12$) would be charged for the first nine months of the year in the consolidated financial statements. Therefore, the total loss of Bikelite in the consolidated financial statements is dinar 6.75 million.

Net assets at disposal in dinars would therefore be dinar 57.25 million (dinar 64 – dinar 6.75).



Tutorial note

It is important to learn the pro-formas for calculating foreign exchange differences. Remember that a profit in the period will increase the opening net assets, but a loss will reduce the opening net assets. Profits and losses are translated at the average rate.

The exchange gain for the year ended 31 December 20X6 would be \$13.4 million calculated as follows:

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

This exchange gain is presented in other comprehensive income. Of the total, \$10.7 million is attributable to the shareholders of Carbise ($80\% \times 13.4 m) and \$2.7 million to the NCI.



Tutorial note

Don't be too disheartened if you make mistakes in your calculations. Lots of students would forget to adjust the opening net assets and loss of Bakelite for the impact of the fair value adjustment. Those students would still score marks for demonstrating knowledge of the key principles involved when translating an overseas subsidiary.

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



Tutorial note

This is an important pro-forma to learn. You will not be penalised if your figures from previous parts of the question are incorrect. Lots of students would forget to reclassify the group's share of the previously recognised foreign exchange gains to profit or loss.

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

Workings

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

NCI at disposal is calculated as follows:

	\$ millions
NCI at 1 January 20X6 per question	47.8
NCI share of loss to 30 September 20X6	
(20% × \$18.2m (part (b)))	(3.6)
NCI share exchange gains for 9 months to 30 September 20X6	
(20% × (\$13.4m + \$8.2m))	4.3
NCI at 30 September 20X6	48.5

(ii) Treatment and presentation of Bikelite

For the year ended 31 December 20X6, Carbise will consolidate Bikelite for the first nine months of the year up to the date of disposal of the shares and subsequent loss of control.

Exchange differences on the translation of the net assets, profits and goodwill in relation to the nine months to 30 September 20X6 will initially be recognised in other comprehensive income.

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



Tutorial note

The presentation of a subsidiary that has been sold during the period, or which is held for sale, depends on whether it qualifies as a discontinued operation. State the relevant principles used to determine whether a component of a business is a 'discontinued operation', and then apply these to the scenario.

Consideration should be given as to whether the disposal of Bikelite would be presented as a discontinued operation. According to IFRS 5 Non-current Assets Held for Sale and Discontinued Operations, for Bikelite to be classified as a discontinued operation, it would need to represent a separate major line of business or geographical area of operations. Since Bikelite was initially acquired by Carbise to gain easier access to international markets, it is likely that the criterion would be met.

	ACCA marking guide	
		Marks
(a)	(i) – discussion of presentation and functional currency	2
	– application of the above discussion to the scenario	5
	Maximum	7
	(ii)	
	(ii) — calculation of goodwill — calculation of the exchange difference on goodwill	2 3
	- calculation of the exchange difference on goodwill	
		5
	(iii) – explanation of the goodwill calculation and application to the	2
	scenario	,
	 explanation of the exchange gain and application to the scenario 	2
	Maximum	4
(b)	 explanation of Bikelite exchange differences 	3
	 calculation of Bikelite exchange differences for y/e 20X6: 	
	translation split between parent and NCI	3 1
	split between parent and NCI	
	Maximum	7
(c)	– calculation of group profit or loss on disposal	3
	 explanation of the accounting treatment of Bikelite 	4
Total		20
iotai		30

Examiner's comments

In the first part, weak answers tended to list the factors determining the functional currency with little application to the scenario.

The technical parts of a consolidation, in this case part (ii), are generally well-answered although some candidates are often less prepared to perform a translation from a foreign currency. Likewise, explanations of calculations within the consolidation process, part (iii), are often well-answered provided that the calculations have been performed well. Although the question is broken into several sections, some candidates insist on answering as if it is one question. Candidates are advised against this because it makes it difficult for markers to mark.



MOYES (DEC 2018) Walk in the footsteps of a top tutor



Key answer tips

This question examines consolidated statements of cash flow. However, note that the calculation of cash generated from operations was only worth six marks. In contrast, discussion of the adjustments made to profit before tax (part (a) (ii)) and discussion of the impact of a change in group structure (part (b)) were worth twelve marks. To succeed in SBR, you must feel confident with the discursive requirements.

When preparing a statement of cash flows (or extracts from the statement), pay careful attention to whether the figures need brackets.

(a) Explanatory note to: The directors of Moyes

Subject: Cash flows generated from operations

(i) Cash generated from operations



Tutorial note

Make sure that your reconciliation is clearly labelled. This will help the markers to award you credit if you have made mistakes.

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



Tutorial note

Note that the same answer would have been obtained if no separate adjustment was made for the \$6\$ million loss on inventories and if the reduction in inventories was presented as \$39\$ million (\$126m - \$165m).

(ii) Explanation of adjustments



Tutorial note

Work through your calculation of cash generated from operations and discuss the rationale behind each adjustment you have made to profit before tax.

Indirect method

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

Associate

The share of profit of associate is an item of income associated with investing activities and so has been deducted.

Non-cash flows

Non-cash flows which have reduced profit and must subsequently be added back include the service cost component, depreciation, exchange losses and impairments. With the impairment of property, plant and equipment, the first \$20 million of impairment will be allocated to the revaluation surplus so only \$23 million would have reduced operating profits and should be added back.

Pension

In relation to the pension scheme, the remeasurement component can be ignored as it is neither a cash flow nor an expense to operating profits. Cash contributions should be deducted, though, as these represent an operating cash payment ultimately to be received by Moyes' employees. Benefits paid to retired employees are a cash outflow for the pension scheme rather than for Moyes and so should be ignored.

Working capital

The movements on receivables, payables and inventory are adjusted so that the timing differences between when cash is paid or received and when the items are accrued in the financial statements are accounted for.

Inventory is measured at the lower of cost and net realisable value. The inventory has suffered an overall loss of \$6 million (Dinar 80 million/5 – Dinar 60 million/6). This is not a cash flow and would be added back to profits in the reconciliation. However, the loss of \$6 million should also be adjusted in the year-on-year inventory movements. The net effect of this on the statement of cash flows will be nil.

(b) Change in structure



Tutorial note

Students are generally good at dealing with changes in group structures in numerical questions. Make sure that you understand the principles behind the numerical treatment so that you are able to address discursive questions as well.

When the parent company acquires or sells a subsidiary during the financial year, cash flows arising from the acquisition or disposal are presented as investing activities.

In relation to Davenport, no cash consideration has been paid during the current year because the consideration consisted of a share for share exchange and deferred cash. The deferred cash would be presented as a negative cash flow within investing activities when paid in two years' time.

This does not mean that there would be no impact on the current year's statement of cash flows. On gaining control, Moyes would consolidate 100% of the assets and liabilities of Davenport which would presumably include some cash or cash equivalents at the date of acquisition. These would be presented as a cash inflow at the date of acquisition net of any overdrafts held at acquisition.

Adjustments would also need to be made to the opening balances of assets and liabilities by adding the fair values of the identifiable net assets at acquisition to the respective balances. This would be necessary to ensure that only the cash flow effects are reported in the consolidated statement of cash flows.

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

Dividends



Tutorial note

The question asked about changes in group structure and dividends. Make sure that you address both aspects. The examining team regularly comment that students fail to address all parts of the exam questions.

Dividends received by Moyes from Davenport are not included in the consolidated statement of cash flows since cash has in effect been transferred from one group member to another.

The non-controlling interest's share of the dividend would be presented as a cash outflow in financing activities.

(c) Assets held for sale



Tutorial note

Start with the definition of an asset held for sale and then apply it to the scenario.

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations defines an asset held for sale as one where the carrying amount will be recovered principally through a sales transaction. To be classified as held for sale, a sale has to be highly probable and the asset should be available for sale in its present condition.

At face value, Watson would not appear to meet this definition as no sales transaction is to take place.

IFRS 5 does not explicitly extend the requirements for held for sale to situations where control is lost. However, the Board have confirmed that in instances where control is lost, the subsidiary's assets and liabilities should be derecognised. Loss of control is a significant economic event and fundamentally changes the investor—investee relationship. Therefore situations where the parent is committed to lose control should trigger a reclassification as held for sale. Whether this should be extended to situations where control is lost to other causes would be judgemental. It is possible therefore that Watson should be classified as held for sale.

Discontinued operations



Tutorial note

Start with the definition of an asset held for sale and then apply it to the scenario. Remember you were asked to discuss both Barham and Watson.

IFRS 5 defines a discontinued operation as a component of an entity which either has been disposed of or is classified as held for sale, and

- represents a separate major line of business or geographical area of operations, or
- (ii) is a single co-ordinated plan to dispose of a separate major line or area of operations, or
- (iii) is a subsidiary acquired exclusively for resale.

Barham has been sold during the year but there appears to be other subsidiaries which operate in similar geographical regions and produce similar products. Little guidance is given as to what would constitute a separate major line of business or geographical area of operations. The definition is subjective and the directors should consider factors such as materiality and relevance before determining whether Barham should be presented as discontinued or not.

The same is true for Watson. Assuming it can be classified as held for sale, it would need to be a separate major line of business or geographical area of operation to be presented as a discontinued operation.

(d) Probability



Tutorial note

This question requires knowledge of the recognition criteria in a range of IFRS and IAS Standards, as well as in the Conceptual Framework. This content is core. If your knowledge here is lacking then you should revisit the Study Text.

Different accounting standards use different levels of probabilities to discuss when assets and liabilities should be recognised in the financial statements. For example, economic benefits from property, plant and equipment and intangible assets need to be probable to be recognised; to be classified as held for sale, the sale has to be highly probable.

Under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* a provision should only be recognised if an outflow of economic resources is probable. Contingent assets, on the other hand, can only be recognised if the inflow is economic benefits is virtually certain. This could lead to a situation where two sides of the same court case have two different accounting treatments despite the likelihood of pay-out being identical for both parties.

Contingent consideration transferred on a business combination is recognised in the financial statements regardless of the level of probability. Instead the fair value is adjusted to reflect the level of uncertainty of the contingent consideration.



Tutorial note

The Conceptual Framework has been recently revised. Ensure your knowledge is upto-date.

In the 2018 *Conceptual Framework*, the Board confirmed a new approach to recognition which requires decisions to be made with reference to the qualitative characteristics of financial information. The *Conceptual Framework* says than an item is recognised if it meets the definition of an element and if recognition provides users of financial statements with:

- relevant information
- a faithful representation of the asset or liability.

The key change in the 2018 Conceptual Framework was therefore to remove the probability criterion. The Conceptual Framework will inform the revision of current IFRS and IAS Standards as well as the development of new standards, and this may mean that more assets and liabilities with a low probability of inflow or outflow of economic resources will be recognised in the future. The Board accepts that prudence could still mean there will be inconsistencies in the recognition of assets and liabilities within financial reporting standards but may be a necessary consequence of providing investors and lenders with the most useful information.

	Marking guide	
		Marks
(a)	calculation of cash flow generated from operations	6
	 explanation of the adjustments and use of the scenario 	6
		12
(b)	 application of the following discussion to the scenario: 	
	purchase consideration (shares and deferred cash) impact on consolidated statement of cash flows of:	1
	subsidiary acquisition (including dividend)	3
	subsidiary disposal	2
		6
(c)	 IFRS 5 definition of discontinued operation and application to the scenario 	3
	 consideration of held for sale and application to the scenario 	1
	 consideration of loss of control and application to the scenario 	2
		6
(-1)	in an attende and in et al. a made delite, attended for death a	
(d)	 inconsistent application of the probability criterion (including examples) 	3
	Conceptual Framework	3
		6
Total		30

Examiner's comments

Statements of cash flow will be examined regularly in the SBR exam as they form part of the group accounting aspect of the syllabus. Many candidates ignored the fact that they had to draft an explanatory note and simply showed the calculation of cash generated from operations. Some candidates showed the accounting entries for the various elements set out in the question even though this was not required. The maximum marks available for simply showing the calculation was 6 marks which represented only half of the marks for this part of the question. To gain these marks, candidates had to ensure that the cash flow adjustments were in the right direction. For example, depreciation had to be added back to profit before tax and not deducted in order to gain credit. Candidates performed well on this part of the question, gaining full marks in many cases.

The second part of the question required an explanation of how the changes to the group structure and dividend would impact upon the consolidated statement of cash flows. This aspect of the syllabus has historically been examined as a calculation but in this exam, candidates were required to explain the principles behind the adjustments to the statement of cash flows. Where attempts were made at explanations in this question then candidates performed quite well.

The third part of the guestion required candidates to advise the directors as to the held for sale and discontinued operation classifications. It is important for candidates to realise that there is only a small number of marks available for simply setting out the rules in IFRS 5 and that the majority of the marks are awarded for the application of the principles in the standard. Also, the question asked for a discussion of both held for sale and discontinued operation criteria and thus it is important for candidates to deal with both issues. However, several candidates focussed on held for sale with little discussion of discontinued operations.

8



BANANA (SEP 2018) Walk in the footsteps of a top tutor



Key answer tips

This question examines core issues in group accounting, such as the calculation of goodwill and the accounting treatment of associates.

In SBR you will be asked to 'discuss' the correct accounting treatment of transactions. Calculations are not enough to pass the exam.

Part (c) tests financial instrument derecognition issues. This is a common exam topic. Make sure that you know the key principles that govern the classification, recognition, measurement, derecognition and impairment of financial instruments.

(a) (i) Goodwill



Tutorial note

This answer involves some calculations but the majority of it is discursive. If you neglect the discussion element then you will not pass.

According to IFRS 3 *Business Combinations*, goodwill should be calculated by comparing the fair value of the consideration with the fair value of the identifiable net assets at acquisition.

The shares have been correctly valued using the market price of Banana at acquisition.

Contingent consideration should be included at its fair value which should be assessed taking into account the probability of the targets being achieved as well as being discounted to present value. It would appear reasonable to measure the consideration at a value of \$4 million (\$16 million \times 25%). A corresponding liability should be included within the consolidated financial statements with subsequent remeasurement. This would be adjusted prospectively to profit or loss rather than adjusting the consideration and goodwill.

The finance director has measured the non-controlling interest using the proportional method rather than at fair value. Although either method is permitted on an acquisition by acquisition basis, the accounting policy of the Banana group is to measure non-controlling interest at fair value. The fair value of the non-controlling interest at acquisition is \$17 million ($20\% \times 20$ million $\times \$4.25$).

Net assets at acquisition were incorrectly included at their carrying amount of \$70 million. This should be adjusted to fair value of \$75 million with a corresponding \$5 million increase to land in the consolidated statement of financial position.



Tutorial note

Goodwill calculations are a common exam topic. Learn the pro-forma.

Goodwill should have been calculated as follows:

	\$m
Fair value of share exchange	68
Contingent consideration	4
Add NCI at acquisition	17
Less net assets at acquisition	(75)
Goodwill at acquisition	14

The correcting entry required to the consolidated financial statements is:

Dr Goodwill \$2 million
Dr Land \$5 million
Cr Non-controlling interest \$3 million
Cr Liabilities \$4 million



Tutorial note

Make sure that your debits and credits balance.

If you don't feel comfortable with debits and credits then you could refer to increases or decreases instead.

(ii) Equity accounting



Tutorial note

There is only one mark available for the correct calculation of the associate's carrying amount. The discussion element is crucial.

If an entity holds 20% or more of the voting power of the investee, it is presumed that the entity has significant influence unless it can be clearly demonstrated that this is not the case. The existence of significant influence by an entity is usually evidenced by representation on the board of directors or participation in key policy making processes. Banana has 40% of the equity of Strawberry and can appoint one director to the board. It would appear that Banana has significant influence but not control. Strawberry should be classified as an associate and be equity accounted for within the consolidated financial statements.

The equity method is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income. At 1 October 20X6, Strawberry should have been included in the consolidated financial statements at a carrying amount of \$20.4 million + \$44 million.

(iii) Disposal



Tutorial note

Show all of your workings. Make sure they are clearly labelled.

On disposal of 75% of the shares, Banana no longer exercises significant influence over Strawberry and a profit on disposal of \$3.1 million should have been calculated.



Tutorial note

You can still score full marks if you answer to part (ii) was incorrect. Markers apply the 'own figure rule'.

	\$m
Proceeds	19.0
Fair value retained	4.5
Carrying amount of associate (part (ii))	(20.4)
Profit on disposal	3.1

Banana is incorrect to have recorded a loss in reserves of \$14 million and this should be reversed. Instead, a gain of \$3.1 million should have been included within the consolidated statement of profit or loss.



Tutorial note

The definition of a financial asset includes an investment in the equity shares of another entity. Lots of students forget this.

If no designation was made to measure the shares at fair value through other comprehensive income then Banana would measure them at fair value through profit or loss.

The retained 10% investment is a financial asset. Per IFRS 9 Financial Instruments it is initially recognised at fair value of \$4.5 million. Banana does not intend to sell their remaining interest so, as long as they make an irrecoverable election, they can treat the remaining interest at fair value through other comprehensive income. The investment will be restated to its fair value of \$4 million at the reporting date with a corresponding loss of \$0.5 million reported in other comprehensive income.

(b) Melon



Tutorial note

If your conclusion differs from the one below then you can still score well. Make sure that you state the relevant rules from the accounting standard and then apply them to the scenario.

Melon should only be treated as an asset acquisition if it does not meet the definition of a business.



Tutorial note

State the definition of a business and then apply it to the scenario.

IFRS 3 Business Combinations defines a business as an integrated set of activities and assets that can be managed to provide goods or services, generate investment income (such as dividends or interest), or generate other income from ordinary activities. To meet this definition, the acquisition must comprise inputs and processes that significantly contribute to the **ability** to turn those inputs into outputs. To qualify as a business, outputs are not required.



Tutorial note

Don't forget the optional concentration test.

The Board has introduced an optional concentration test that helps entities to conclude whether an acquisition is **not** a business. The concentration test is met if substantially all of the fair value of the total assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets.

In the case of Melon, two types of assets appear to have been acquired: a licence, and research activities. The research activities appear to be at a very early stage and, whilst in substance are very different in nature to the licence itself, are likely to be of relatively low value. It is therefore plausible that substantially all of the fair value is concentrated in the licence itself. If so, the acquisition would not be treated as a business combination.

Should it be determined that the research activities are of sufficient value then this means that not all the fair value is concentrated in a single asset. This would necessitate a more detailed assessment of the inputs and processes acquired.

The licence and the research activities are inputs. However, to qualify as a business, a process must have been acquired that would significantly contribute to the ability to turn these into output. Per IFRS 3 an acquired process is only substantive if:

- it is critical to convert an input to an output, and
- inputs acquired include a knowledgeable, skilled, organised workforce able to perform that process on other acquired inputs to produce outputs.

A skilled and knowledgeable workforce with the ability to complete the research has not been acquired because there are no employees and the outsourcing contracts have expired. As such, Banana has not acquired a substantive process. The directors' proposal to treat Melon as an asset purchase, rather than a business combination, was therefore correct.

(c) Bonds



Tutorial note

The bonds have been 'sold' so a key issue in this question concerns derecognition. In other words, should the financial asset be removed from the statement of financial position? Begin your answer with the rules governing derecognition from IFRS 9 Financial Instruments. Then apply these rules to the bond sale.

IFRS 9 Financial Instruments requires that a financial asset only qualifies for derecognition once the entity has transferred the contractual rights to receive the cash flows from the asset or where the entity has retained the contractual rights but has an unavoidable obligation to pass on the cash flows to a third party. The substance of the disposal of the bonds needs to be assessed by a consideration of the risks and rewards of ownership.

Banana has not transferred the contractual rights to receive the cash flows from the bonds. The third party is obliged to return the coupon interest to Banana and to pay additional amounts should the fair values of the bonds increase. Consequently, Banana still has the rights associated with the interest and will also benefit from any appreciation in the value of the bonds. Banana still retains the risks of ownership as it has to compensate the third party should the fair value of the bonds depreciate in value.

If the sale were a genuine transfer of risks and rewards of ownership, then the sales price would be approximate to the fair value of the bonds. It would only be in unusual circumstances, such as a forced sale of Banana's assets arising from severe financial difficulties, that this would not be the case. The sales price of \$8 million is well below the current fair value of the bonds of \$10.5 million. Additionally, Banana is likely to exercise their option to repurchase the bonds.

It can be concluded that no transfer of rights has taken place and therefore the asset should not be derecognised.



Tutorial note

Once you have reached a conclusion about derecognition then you need to think in more detail about the specific financial statement impact of the transaction in the year ended 30 June 20X7.

To measure the asset at amortised cost, the entity must have a business model where they intend to collect the contractual cash flows over the life of the asset. Banana maintains these rights and therefore the sale does not contradict its business model. The bonds should continue to be measured at amortised cost in the consolidated financial statements of Banana.

The carrying amount of the bonds at 30 June 20X6 would have been \$10.2 million ($$10 \text{ million} + (7\% \times $10\text{m}) - (5\% \times $10\text{m})$). Amortised cost prohibits restatement to fair value. The carrying amount of the bonds at 30 June 20X7 should be \$10.4 million ($$10.2\text{m} + (7\% \times $10.2\text{m}) - (5\% \times $10\text{m})$).

The proceeds received of \$8 million should be recognised as a financial liability measured at amortised cost. An interest charge of \$0.8 million would accrue between 1 July 20X6 and 1 July 20X8, being the difference between the sale and repurchase price of the bonds.

		Marking scheme	
			Marks
(a)	(i)	Goodwill and contingent consideration	3
		Why existing goodwill calculation is incorrect	3
		Correct calculation and entry	2
			8
	(ii)	Significant influence	2
	. ,	Equity accounting	1
		Carrying amount	1
		carrying amount	
			4
	(iii)	Calculation of gain	1
	()	Rationale for gain	1
		Correct treatment after disposal	2
		correct deathers are alsposar	
			4
(b)		Discussion of business combinations	7
(6)		Discussion of business combinations	, ,
(c)		Consideration of IFRS 9 principles	4
(0)		Transfer of rights/conclusions	1
		Carrying amount of bonds	2
		Carrying amount or bonus	
			7
			,
Total			30
iotai			30

Examiner's comments

Many candidates gained high marks in the first part, provided they separated the complex calculations from their explanations. Techniques such as producing the calculations on one page whilst simultaneously explaining them on a second page proved an efficient exam technique. Whilst most candidates are naturally drawn to the numbers, most of the marks in this section were allocated to the explanation and the application of IFRS 3 *Business Combinations*. Weak answers to (i) provided insufficient explanation of the accounting treatment relating to each aspect of the goodwill calculation, for which marks were available if explained. Part (ii) was generally well-answered although in some cases the carrying amount of the associate was overlooked or incorrect. In part (iii) explanations were generally good, although the disposal calculation was often incorrect (for example, omitting the fair value of the retained investment).

Part (b) was generally weak. Many answers focused on defining an asset, with minimal reference to the requirements of a business combination under IFRS 3. In part (c), providing that candidates identified the key aspect of substance, marks were awarded accordingly.

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Key answer tips

It is important to be able to calculate the exchange differences that arise when an overseas subsidiary is translated into the presentation currency of the group. Memorise the necessary pro-formas before attempting this question.

The consolidation question in the Strategic Business Reporting exam is likely to require both discussion and calculations. Easy marks can be obtained on the former, but students tend to prioritise the latter.

(i) Goodwill (a)



Tutorial note

The question asks you to 'advise'. Calculations alone are not sufficient to score full marks.

IFRS 3 Business Combinations says that goodwill is recognised at the acquisition date. It is calculated as the difference between:

- the total of the fair value of the consideration transferred to acquire control and the non-controlling interest, and
- the fair value of the subsidiary's identifiable net assets.

According to IAS 21 The Effects of Changes in Foreign Exchange Rates, goodwill arising on acquisition of foreign operations is treated as the foreign operation's asset. At each reporting date, it is translated at the closing rate of exchange. Goodwill should be reviewed for impairment annually.

Goodwill is calculated initially in foreign currency as follows:

	Dm
Fair value of consideration ($$46m \times 8$)	368
NCI at acquisition (210m shares × 40% × 2.62 dinars)	220
Fair value of identifiable net assets (W1)	(488)
Goodwill at acquisition	100
Impairment (20%)	(20)
Goodwill at reporting date	80

The goodwill of Tyslar as at 31 October 20X5 is therefore \$8.4 million (D80m/9.5).

(W1) Net assets at acquisition

210
258
20
488

The subsidiary's net assets should be measured in the consolidated financial statements at fair value at the acquisition date. As such, the land carried at 50m dinars in the separate financial statements should be remeasured to 70m dinars (and then translated into dollars at the appropriate rate).

(ii) Translation reserve

Foreign exchange differences arise when translating Tyslar into the presentation currency of the group. This is because:

- goodwill is retranslated every year at the closing rate
- the opening net assets are retranslated every year at the closing rate
- profit for the year is translated in the statement of profit or loss at the average rate but net assets in the statement of financial position are translated at the closing rate.

Exchange differences arising on the retranslation of an overseas subsidiary are recorded in other comprehensive income. They are presented as an item that may be reclassified to profit or loss in the future.

Exchange differences arising on the translation of the subsidiary's opening net assets and profit are attributable to the owners of the group and the non-controlling interest (NCI). Exchange differences arising on the translation of goodwill are attributable to the owners of the group and the NCI if the NCI at acquisition was valued at its fair value.

The exchange differences attributable to the owners of the group are held in a translation reserve in equity. This is calculated as follows:

	ŞIII
Group share of goodwill forex loss (W2)	(1.0)
Group share of net asset and profit forex loss (W3)	(6.1)
	(7.1)

(W2) Exchange loss on Tyslar's goodwill



Tutorial note

If goodwill is calculated using the fair value method, the exchange gain or loss and any impairment must be apportioned between the group and the NCI.

		Exchange	
	Dm	rate	\$m
Opening (acquisition) goodwill			
(part (a) (i))	100	8.0	12.5
Impairment (part (a) (i))	(20)	8.5	(2.4)
Exchange loss (bal. fig)			(1.7)
Closing goodwill	80	9.5	8.4

Goodwill has been calculated using the fair value method. Therefore, the exchange loss must be allocated between the group and the NCI based on their respective shareholdings.

Group: $$1.7m \times 60\% = $1.0m$ NCI: $$1.7m \times 40\% = $0.7m$

(W3) Exchange loss on Tyslar's opening net assets and profit



Tutorial note

Make sure that you learn this pro-forma.

	Dm	Exchange rate	\$m
Net assets at 1 Nov 20X4 (part (a) (i))	488	8.0	61.0
Profit for the year (D522m (W4) – D488m) Exchange loss (bal. fig)	34	8.5	4.0 (10.1)
Net assets at 31 Oct 20X5 (W4)	522	9.5	54.9

The exchange loss on the opening net assets and profit must be allocated between the group and the NCI based on their respective shareholdings:

Group: $$10.1m \times 60\% = $6.1m$ NCI: $$10.1m \times 40\% = $4.0m$