(W4) Net assets at reporting date

	Dm
Share capital	210
Retained earnings	292
Fair value adjustment	20
	522

(iii) Overseas property

The property should have been recognised at \$7 million, which is the fair value of the consideration transferred to acquire it. A profit on the disposal of the land of \$2 million (\$7m - \$5m) should also have been recorded. The correcting entry is:

Dr PPE \$2m

Cr P/L \$2m

The staff relocation costs should not have been capitalised. The correcting entry is:

Dr P/L \$0.5m

Cr PPE \$0.5m

The building should be depreciated over its useful life, giving a current year charge of \$0.1 million ($$7m/35 \times 6/12$):

Dr P/L \$0.1m

Cr PPE \$0.1m

At the reporting date, the building should be revalued from its carrying amount of 6.9 million (7m - 0.1m) to its fair value of 7.9 million (D75m/9.5). The gain is recorded in other comprehensive income. The entry to record it is:

Dr PPE \$1.0m

Cr OCI \$1.0m

The total property, plant and equipment balance is calculated as follows:

	\$m
Bubble	280.0
Tyslar (D390/9.5)	41.1
Tyslar fair value adjustment (D20m/9.5)	2.1
PPE cost adjustment	2.0
Removal of incorrect costs	(0.5)
Depreciation	(0.1)
Revaluation	1.0
	325.6

(b) Functional currency



Tutorial note

Remember to state the rules (how is a functional currency determined) and then apply those rules to the scenario.

IAS 21 The Effects of Changes in Foreign Exchange Rates says that the functional currency is the currency of the primary economic environment in which the entity operates. The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash.

The following factors should be considered in determining Tyslar's functional currency:

- The currency that mainly influences the determination of the sales prices
- The currency of the country whose competitive forces and regulations mainly influences operating costs.

The currency that dominates the determination of sales prices will normally be the currency in which the sales prices for goods and services are denominated and settled. In Tyslar's case, sale prices are influenced by local demand and supply, and are traded in dinars. Analysis of the revenue stream points to the dinar as being the functional currency. The cost analysis is indeterminate because the expenses are influenced by the dinar and the dollar.

IAS 21 also requires entities to consider secondary factors when determining the functional currency. These factors include the degree of autonomy and the independence of financing. Tyslar operates with a considerable degree of autonomy both financially and in terms of its management. Tyslar does not depend on the group for finance.

In conclusion, Tyslar's functional currency will be the dinar because its revenue is clearly influenced by the dinar.

	Marking scheme	
		Marks
(a)	Goodwill calculation and discussion	7
	Group translation reserve	10
1	Property, plant and equipment	7
(b)	Functional currency discussion – 1 mark per point	6
Total		30

10



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Key answer tips

There are always easy marks in cash flow questions – read the question very carefully and you should find lots of figures that can be put straight into your pro-forma. Make sure that you get your brackets the right way around or you will lose marks.

Acquisition of Tigret (a) (i)

Jocatt obtained control over Tigret in stages (also known as a 'step acquisition'). On 30 June 20X2, Jocatt should have revalued the previous 8% investment to its fair value of \$5 million and it in the goodwill calculation. This adjustment will increase goodwill by \$5 million. A gain of \$1 million (\$5m -\$4m) should have been recorded in the consolidated statement of profit or loss. The adjusting entry is:

Dr Goodwill \$5m

Cr Financial assets \$4m

Cr Profit or loss \$1m

The identifiable net assets of Tigret at acquisition are consolidated at their fair value of \$45 million. This creates a taxable temporary difference of \$10 million because the carrying amount of the net assets in the consolidated financial statements exceeds the tax base of \$35 million. A deferred tax liability arises for \$3 million ($$10m \times 30\%$) in the consolidated statement of financial position. This is treated as part of the subsidiary's acquisition net assets and therefore goodwill at acquisition will also increase by \$3 million:

Dr Goodwill \$3m

Cr Deferred tax liabilities \$3m

Goodwill at the acquisition date is calculated as follows:

	\$m
Fair value of consideration (\$15m + \$15m)	30
Fair value of previous equity interest	5
Fair value of non-controlling interest	20
Fair value of net assets at acquisition (excl. deferred tax)	(45)
Deferred tax	3
Goodwill on acquisition	13



Tutorial note

An alternative calculation for goodwill would be:

\$5m draft + \$5m step acquisition adjustment + \$3m deferred tax adjustment = \$13 million

(ii) Extracts from Jocatt Group: Statement of Cash flows for the year ended 30 November 20X2

Cash flows from operating activities: Profit before tax (\$44m + \$1m gain on Tigret) 45 Finance costs 8 Retirement benefit service cost 16 Depreciation 27 Gain on investment property (W2) (2) Profit on sale of land (\$19m - \$10m) (9) Impairment of goodwill (W1) 33 Gain on Tigret (1) Cash paid to retirement benefit scheme (W4) (7) Decrease in trade receivables (\$62m - \$113m - \$5m) 56 Decrease in inventories (\$105m - \$128m) 23 Increase in trade payables (\$144m - \$55m - \$6m) 83 Cash generated from operations 272 Interest paid (\$8m - \$2m interest on defined benefit plan) (6) Income taxes paid (W3) (18)	•
Finance costs Retirement benefit service cost Depreciation Gain on investment property (W2) Profit on sale of land (\$19m - \$10m) Impairment of goodwill (W1) Gain on Tigret (1) Cash paid to retirement benefit scheme (W4) Decrease in trade receivables (\$62m - \$113m - \$5m) Decrease in inventories (\$105m - \$128m) Increase in trade payables (\$144m - \$55m - \$6m) Cash generated from operations Interest paid (\$8m - \$2m interest on defined benefit plan) (6)	
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Depreciation 27 Gain on investment property (W2) (2) Profit on sale of land (\$19m - \$10m) (9) Impairment of goodwill (W1) 33 Gain on Tigret (1) Cash paid to retirement benefit scheme (W4) (7) Decrease in trade receivables (\$62m - \$113m - \$5m) 56 Decrease in inventories (\$105m - \$128m) 23 Increase in trade payables (\$144m - \$55m - \$6m) 83 Cash generated from operations 272 Interest paid (\$8m - \$2m interest on defined benefit plan) (6)	Finance costs
Gain on investment property (W2) Profit on sale of land (\$19m - \$10m) Impairment of goodwill (W1) Gain on Tigret (1) Cash paid to retirement benefit scheme (W4) Decrease in trade receivables (\$62m - \$113m - \$5m) Decrease in inventories (\$105m - \$128m) Increase in trade payables (\$144m - \$55m - \$6m) Cash generated from operations Interest paid (\$8m - \$2m interest on defined benefit plan) (6)	Retirement benefit serv
Profit on sale of land (\$19m - \$10m) (9) Impairment of goodwill (W1) 33 Gain on Tigret (1) Cash paid to retirement benefit scheme (W4) (7) Decrease in trade receivables (\$62m - \$113m - \$5m) 56 Decrease in inventories (\$105m - \$128m) 23 Increase in trade payables (\$144m - \$55m - \$6m) 83 Cash generated from operations 272 Interest paid (\$8m - \$2m interest on defined benefit plan) (6)	Depreciation
Impairment of goodwill (W1) Gain on Tigret (1) Cash paid to retirement benefit scheme (W4) Decrease in trade receivables (\$62m - \$113m - \$5m) Decrease in inventories (\$105m - \$128m) Increase in trade payables (\$144m - \$55m - \$6m) Cash generated from operations Interest paid (\$8m - \$2m interest on defined benefit plan) (6)	Gain on investment pro
Gain on Tigret (1) Cash paid to retirement benefit scheme (W4) Decrease in trade receivables (\$62m - \$113m - \$5m) Decrease in inventories (\$105m - \$128m) Increase in trade payables (\$144m - \$55m - \$6m) Cash generated from operations Interest paid (\$8m - \$2m interest on defined benefit plan) (6)	Profit on sale of land (\$2
Cash paid to retirement benefit scheme (W4) (7) Decrease in trade receivables (\$62m - \$113m - \$5m) 56 Decrease in inventories (\$105m - \$128m) 23 Increase in trade payables (\$144m - \$55m - \$6m) 83 Cash generated from operations 272 Interest paid (\$8m - \$2m interest on defined benefit plan) (6)	Impairment of goodwill
Decrease in trade receivables (\$62m - \$113m - \$5m) 56 Decrease in inventories (\$105m - \$128m) 23 Increase in trade payables (\$144m - \$55m - \$6m) 83 Cash generated from operations 272 Interest paid (\$8m - \$2m interest on defined benefit plan) (6)	Gain on Tigret
Decrease in inventories (\$105m - \$128m) Increase in trade payables (\$144m - \$55m - \$6m) Cash generated from operations Interest paid (\$8m - \$2m interest on defined benefit plan)	Cash paid to retirement
Increase in trade payables (\$144m - \$55m - \$6m) Cash generated from operations Interest paid (\$8m - \$2m interest on defined benefit plan) (6)	Decrease in trade receiv
Cash generated from operations 272 Interest paid (\$8m - \$2m interest on defined benefit plan) (6)	Decrease in inventories
Interest paid (\$8m – \$2m interest on defined benefit plan) (6)	Increase in trade payabl
Interest paid (\$8m – \$2m interest on defined benefit plan) (6)	Cook compared from on
(\$8m – \$2m interest on defined benefit plan) (6)	
——————————————————————————————————————	
	meome taxes paid (vvs)
248	
Cash flows from financing activities:	Cash flows from financi
Repayment of long-term borrowings (\$71m – \$67m) (4)	Repayment of long-term
Non-controlling interest dividend (per SOCIE) (11)	Non-controlling interest
Dividends paid by Jocatt (per SOCIE) (5	Dividends paid by Jocatt
(20)	

Workings

(W1) Goodwill



Tutorial note

Reconcile the movement in the carrying amount of goodwill between the two reporting dates to calculate the impairment. This should be added back in the reconciliation between profit before tax and cash generated from operations.

	\$m
Opening balance at 1 December 20X1	68
Acquisition of Tigret (part (i))	13
Impairment (bal. fig.)	(33)
Closing balance at 30 November 20X2	48.0
(\$40m + \$8m (part (i)))	

(W2) Investment property



Tutorial note

Fair value gains and losses on investment properties are recorded in the statement of profit or loss.

	\$m
Opening balance at 1 December 20X1	6
Gain (bal. fig.)	2
Closing balance at 30 November 20X2	8

(W3) Taxation



Tutorial note

Reconcile the opening and closing balances for both the income tax liability and the deferred tax liability in a single working. Remember to include any charge for the year included in profit or loss and also in other comprehensive income. You should also ensure that you correctly deal with any tax-related balances on a subsidiary acquired or disposed of during the year.

	\$m
Opening tax balances at 1 December 20X1 (\$41m + \$30m)	71
Deferred tax on acquisition (part (i))	3
Charge for year per profit or loss	11
Charge for year in OCI	1
Tax paid (bal. fig.)	(18)
Closing tax balances at 30 November 20X2	68
(\$32m + \$3m (part (i)) + \$33m)	

(W4) Defined benefit scheme



Tutorial note

The movement on the defined benefit plan during the year comprises the service cost component, the net interest component, and the remeasurement component. Remember that the remeasurement component is taken to other comprehensive income for the year – it is therefore not an item that should be adjusted for within operating activities. The cash contributions paid into the plan are presented in operating activities.

	\$m
Opening balance at 1 December 20X1	22
Service cost component	16
Net interest component	2
Net remeasurement component gain for year (per OCI)	(8)
Contributions paid (bal. fig.)	(7)
Closing balance at 30 November 20X2	25

(b) Indirect and direct method

The direct method presents separate categories of cash inflows and outflows whereas the indirect method is a reconciliation of profit before tax reported in the statement of profit or loss to the cash flow from operations. The adjustments include non-cash items in the statement of profit or loss plus operating cash flows that were not included in profit or loss.

A problem for users is the fact that entities can choose the method used. This limits comparability.

The majority of companies use the indirect method for the preparation of statements of cash flow. Most companies justify this on the grounds that the direct method is too costly.

Users often prefer the direct method because it reports operating cash flows in understandable categories, such as cash collected from customers, cash paid to suppliers, cash paid to employees and cash paid for other operating expenses. When presented in this way, users can assess the major trends in cash flows and can compare these to the entity's competitors.

The complicated adjustments required by the indirect method are difficult to understand and can be confusing to users. In many cases these adjustments cannot be reconciled to observed changes in the statement of financial position.

		Marking scheme	
			Marks
(a)	(i)	Acquisition of Tigret – 1 mark per point	7
	(ii)	Profit before tax	1
		Finance costs	1
		Retirement benefit expense	1
		Depreciation on PPE	1
		Revaluation gain on investment property	1
		Profit on sale of land	1
		Impairment of goodwill	1
		Gain on Tigret	1
		Decrease in trade receivables	1
		Decrease in inventories	1
		Increase in trade payables	1
		Cash paid to defined benefit scheme	1
		Finance costs paid	1
		Income taxes paid	2
		Repayment of long-term borrowings	1
		Non-controlling interest dividend	1
		Dividends paid	1
			17 max
(b)		1 mark per point	6
Total			30



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Key answer tips

In the Strategic Business Reporting exam, it is unlikely that you will be asked to produce full consolidated statements. The questions are more likely to involve explanation and/or the preparation of extracts. Students tend to find this harder, and often say that they are unsure what they need to write. It is therefore crucial to carefully debrief the answer to this question, and learn from the things that you missed. Remember, practice makes perfect.

(a) (i) Ginny

First nine months



Tutorial note

Don't jump straight to the disposal calculation. After all, Zippy did not dispose of the shares until nine months into the reporting period.

For the first nine months' of the year Zippy had control over Ginny and so Ginny was a subsidiary during this time. Zippy must consolidate Ginny's incomes and expenses and other comprehensive income (OCI) on a line-by-line basis for the first nine months' of the year.

Ginny made a profit of \$32 million for the 12 month period so \$24 million (9/12 \times \$32 million) of this must be consolidated. Of this \$9.6 million (\$24m \times 40%) is attributable to the non-controlling interest.

Ginny recorded OCI of \$16 million for the 12 month period so \$12 million (9/12 \times \$16m) must be consolidated. Of this \$4.8 million (\$12m \times 40%) is attributable to the non-controlling interest.

Loss of control



Tutorial note

Remember that not all share sales lead to a loss of control. If control is retained then no profit or loss arises and the transaction is instead accounted for in equity.

The share sale results in Zippy's holding in Ginny falling from 60% to 40% of the equity shares. Zippy has therefore lost control of Ginny. The difference between the proceeds from the disposal (including the fair value of the shares retained) and the goodwill, net assets and NCI of Ginny at the disposal date will give rise to profit or loss on disposal.

This is calculated as follows:



Tutorial note

It is important to remember the following pro-forma. It is worth a lot of marks.

Proceeds Fair value of remaining interest	\$m	\$m 44 62
		106
Goodwill at disposal (W1)	26	
Net assets at disposal (W2)	154	
Non-controlling interest at disposal (W3)	(66)	
Carrying amount of sub at disposal		(114)
Loss on disposal		(8)

When preparing the consolidated statement of profit or loss, the gain of \$14 million reported in Ginny's individual financial statements must be removed from investment income. The group will instead report an \$8 million loss on disposal.

The remaining investment



Tutorial note

After a subsidiary disposal, students commonly forget to account for the remaining investment. Very easy marks can be scored here.

The remaining 40% investment in Ginny gives Zippy significant influence. As such, Ginny is an associate of Zippy and should be accounted for using the equity method. This means that the group recognises its share of the associate's profit after tax, and its share of the associate's OCI.



Tutorial note

Don't forget to account for the group's share of the associate's other comprehensive income.

The consolidated statement of profit or loss and OCI will show the following amounts:

	\$m
Share of profits of associate	
(40% × 3/12 × \$32m)	3.2
Share of other comprehensive income of associate	
(40% × 3/12 × \$16m)	1.6

Workings



Tutorial note

Set out your workings clearly.

(W1) Goodwill at disposal

	\$m
Fair value of consideration	90
Fair value of non-controlling interest	50
Fair value of identifiable net assets acquired	(114)
Goodwill	26

(W2) Net assets at disposal



Tutorial note

The question tells you the net assets of Ginny at the start of the year. You need to add on nine months' of total comprehensive income in order to work out the net assets at the disposal date.

	\$m
Net assets at 1 July 20X5 per question	118
Profit to 31 March 20X6 (9/12 × \$32m)	24
OCI to 31 March 20X6 (9/12 × \$16m)	12
	154

(W3) NCI at disposal



Tutorial note

When working out the group profit or loss on disposal it is normally wise to leave the NCI at disposal until last. This is because the calculation requires the subsidiary's net assets at the disposal date.

	\$m
Non-controlling interest at acquisition	50
NCI share of post-acquisition net asset movement	
(40% × (\$154m (W2) – \$114m))	16
	66

(ii) Ten floor office block



Tutorial note

In this part of the question, there are more marks available for the discussion than for calculations.

IAS 40 *Investment Property* says that portions of a property can be classified as investment property if they can be sold or leased out separately from the rest of the building.

Property occupied by a subsidiary does not qualify as investment property in the consolidated financial statements, because it is being used by the group. The first two floors of Zippy's office block should therefore be classified as property, plant and equipment in the consolidated financial statements.

Depreciation of \$1.2 million (($$90m \times 0.2$)/15 years) should therefore be charged to administrative costs.

The first two floors should be revalued to \$19.2 million ($$96m \times 0.2$) in the statement of financial position. A revaluation gain should be recorded within other comprehensive income of \$2.4 million ($$19.2m - (($90m \times 0.2) - $1.2m)$).

The remaining eight floors qualify as investment property. Investment property measured at fair value is not depreciated. Fair value gains relating to investment properties are recorded in profit or loss.

These eight floors should be revalued to \$76.8 million ($$96m \times 0.8$) in the statement of financial position. A revaluation gain of \$4.8 million will be recorded in investment income in the statement of profit or loss ($$76.8m - ($90m \times 0.8)$).

Explosion

IAS 36 *Impairment of Assets* does not apply to investment property that is measured at fair value. Investment properties under the fair value model are simply restated to fair value with the gains and losses recorded in profit or loss.

The building should be revalued to \$14 million and a 6 million loss (20m - 14m) should be charged to investment income.

IAS 37 Provisions, Contingent Liabilities and Contingent Assets says that a provision should be recognised if there is an obligation from a past event that will lead to a probable outflow of economic benefits that can be measured reliably. The provision of \$3 million should be reversed through other expenses as there is no obligation to carry out the repairs.

(iii) Individual financial statements

According to IFRS 10 *Consolidated Financial Statements,* consolidated financial statements present the parent and its subsidiaries as a single economic entity.

The second floor of the ten floor office block is being used by another group member. This means that it is being used within the single economic entity for administrative purposes. The second floor must therefore be classified as property, plant and equipment in the consolidated financial statements.

In the individual financial statements of Zippy, the second floor qualifies as an investment property because it is part of a building held to earn rental income (even though no rent is currently charged on the second floor).

As a result of this classification difference, the depreciation charge in the individual financial statements will be lower than in the consolidated financial statements. The carrying amount of investment properties will be higher than in the consolidated financial statements. The revaluation gain in OCI will be lower and the gain in profit or loss will be higher than in the consolidated financial statements.

(b) Other comprehensive income



Tutorial note

Other comprehensive income is a popular exam topic. Make sure that you are aware of current debates around its nature and use.

Profit or loss includes all items of income and expense except those which are recognised in other comprehensive income (OCI) as required or permitted by IFRS Standards.

The *Conceptual Framework* states that profit or loss is the primary source of information about the financial performance of an entity and so income and expenses are normally recognised in that statement. According to the *Conceptual Framework*, an income or expense is presented in other comprehensive if it results from remeasuring an item to current value and if it means that:

- profit or loss provides more relevant information, or
- a more faithful representation is provided of an entity's performance.

The Board makes decisions about OCI on a standard-by-standard basis, as these are revised or issued.

Income and expenditure included in other comprehensive income should be reclassified to profit or loss when doing so results in profit or loss providing more relevant information. Again these decisions are made on a standard-by-standard basis. The Board may decide that reclassification is not appropriate if there is no clear basis for identifying the amount or timing of the reclassification.

With regards to defined benefit pension schemes, the service cost is immediately recognised in profit or loss. The remeasurement component is recognised as other comprehensive income and presented as an item not to be reclassified to the profit or loss in the future. The remeasurement component comprises errors within actuarial assumptions about life expectancy, wage inflation, service lives as well as differences between actual and expected returns. It can be argued that there is no correlation between such items and the underlying performance of an entity, thus justifying the decision that this should never be reclassified to profit or loss.

That said, reclassification is criticised for adding unnecessary complexity to financial reporting and potentially enabling earnings management. Reclassification could be easily misunderstood as essentially the same gain gets reported twice, once within OCI and once within profit or loss. Additionally it is likely that there will be a mismatch on reclassification as the gains or losses may be reported in a different period to when the underlying change in value of the asset or liability took place.

Pensions and immediate recognition

Actuarial gains and losses vary significantly from one year to the next. Immediate recognition may create volatility within the statement of financial position and other comprehensive income. It is, however, important that users are fully aware as to the extent of an entity's pension scheme obligations. This may not be evident if there is a deferral of the remeasurement component. It can be argued therefore that the immediate recognition leads to greater transparency of the financial statements.

Marking scheme			
			Marks
(a)	(i)	Discussion – 1 mark per point	5
		Calculations	6
			11
	(ii)	Property discussion and calcs – 1 mark per point	8
	(11)	Property discussion and cales — I mark per point	·
	(iii)	Individual financial statements – 1 mark per point	4
(b)	OCI -	- 1 mark per point	7
Total			30

12 ASHANTI



Key answer tips

Parts (a) (i) and (ii) require you to explain the treatment of the share sales. Easy marks are available for your discussion – do not jump straight into calculations or you will miss these.

Present workings clearly. You can still score highly even if you get the wrong answer.

If you don't know how to deal with a specific number or a transaction then leave it out (or guess!). There is no negative marking.

(a) (i) Sale of shares in Bochem



Tutorial note

When dealing with the sale of shares in a subsidiary company, it is vital to establish whether or not the parent has lost control.

Ashanti's sale of shares in Bochem does not lead to a loss of control. Consequently there is no gain or loss to the group arising on this transaction and goodwill is not recalculated. Instead, the transaction is accounted for within equity, as an increase in the non-controlling interest (from 30% to 40%).

The non-controlling interest (NCI) in equity will be increased by \$25.1 million (W1). The proceeds received from the sale exceed the increase in the NCI by \$8.9 million (W1), and so other components of equity will be increased by this amount.

(W1) Control-to-control calculation

		\$m
Proceeds of share disposal		34.0
Carrying amount of Bochem at sale date:		
Net assets (W2)	216.0	
Goodwill (80% × \$44m)	35.2	
	251.2	
Change in NCI (10% × 251.2)		25.1
Increase in OCE		8.9

(W2) Net assets

	Acquisition date	Reporting date
	\$m	\$m
Equity shares	55 –	1
Retained earnings	85	210
Other equity components	10	J
FVA – plant (bal fig)	10	10
Dep'n (\$10m/5 × 2 years)		(4)
	160	216

(ii) Sale of shares in Ceram



Tutorial note

If control over a company is lost then a profit or loss on disposal must be calculated. Take time to memorise the pro-forma for calculating this profit or loss.

Ashanti controlled Ceram for the first 6 months of the year, and so will consolidate 6/12 of its revenues and costs.

Mid-way through the year, Ashanti has lost control over Ceram. At this point Ceram is derecognised from the consolidated statement of financial position and a gain or loss on disposal arises in the consolidated statement of profit or loss.

This is calculated as follows:

	\$m	\$m
Proceeds		90.0
Fair value of residual holding at disposal date		45.0
		135.0
Carrying amount of Ceram at disposal:		
Net assets at disposal	160.0	
Goodwill at disposal (W3)	6.2	
NCI at disposal	(35.0)	
		(131.2)
Profit on disposal		3.8



Tutorial note

Don't forget to discuss the treatment of the remaining shares.

The remaining 30% interest in Ceram gives Ashanti significant influence. Therefore, from this date, Ceram is an associate and is accounted for using the equity method. The consolidated statement of profit or loss will report profits from associates of \$2.1\$ million $(6/12 \times $14m \times 30\%)$.

(W3) Goodwill calculation

	\$m
Consideration	95.2
Fair value of NCI at acquisition	26.0
	121.2
Fair value of net assets at acquisition	(115.0)
Goodwill at acquisition/reporting date	6.2

(iii) Revenue and cost of sales



Tutorial note

Set out your workings clearly.

Revenue and cost of sales are calculated as follows:

Revenue

	\$m
Ashanti	810
Bochem	235
Ceram (\$142m × 6/12)	71
Intra-group (W5)	(15)
Sale to Spice (W6)	(5)
	1,096

Cost of sales

Cost of sales	
	\$m
Ashanti	686
Bochem	137
Ceram (\$84m × 6/12)	42
Depreciation (W4)	2
Intra-group (W5)	(15)
Unrealised profits (W5)	1
	853

(W4) Depreciation

The fair value adjustment relating to Bochem's plant is \$10 million (W2).

One year's worth of depreciation must be charged in the consolidated statement of profit or loss. This amounts to \$2 million (\$10m / 5 years).

Dr Cost of sales \$2m

Cr Property, plant and equipment \$2m

(W5) Intra-group trading



Tutorial note

Most consolidated profit or loss questions involve intra-group trading. Make sure that you are happy with the required adjustments because they are a source of easy marks.

Ashanti has sold goods to both Bochem and Ceram. Group revenue and cost of sales will need to be reduced by \$15 million (\$10m + \$5m).

Dr Revenue \$15m

Cr Cost of sales \$15m

An adjustment is required to remove the unrealised profits within group inventory as a result of the sale to Bochem. The unrealised profits amount to \$1 million ($$10m \times 20\% \times \frac{1}{2}$).

Dr Cost of sales \$1m

Cr Inventory \$1m

(W6) Sale to Spice

IFRS 15 Revenue from Contracts with Customers says that a contract with a customer should only be accounted for if:

- The parties have approved the contract
- Rights and obligations can be identified from the contract
- Payment terms can be identified
- The contract has commercial substance
- It is probable that the seller will collect the consideration they are entitled to

Based on the information available, it would seem that the final criterion was not met. Therefore, the contract cannot be accounted for and no revenue should have been recognised.

The revenue recognised by Ashanti on this date must be reversed:

Dr Revenue \$5m

Cr Receivables \$5m

(b) Control



Tutorial note

Start by stating the definition of control, as found in IFRS 10 Consolidated Financial Statements. Apply this definition to the scenario and reach an explicit conclusion about whether Ashanti will assume control over Night.

According to IFRS 10 *Consolidated Financial Statements*, an investor controls an investee if the investor 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

When assessing whether control exists, the following should be considered:

- The size of the entity's holding compared to the size of the holding of other investors
- Whether the entity can direct the relevant activities of the investee (such as decisions about operations, capital expenditure, and the appointment and remuneration of key personnel)
- How dispersed the other shareholdings are
- Any potential voting rights (such as those arising from convertible instruments or options) held by the entity or by other entities
- Whether investors are related parties of one another, or if they have close business relationships.

A 49.9% holding is less than 50%, meaning that Ashanti will not have a controlling holding in the voting shares of Night. However, a 49.9% holding is very close to a majority shareholding.

One of the investors will have a holding of greater than 20%, which suggests significant influence. This might place doubt on the ability of Ashanti to control Night. However, IFRS 10 states that it is possible to control an entity when another investor has significant influence. Whilst the other shareholders could vote together as a block and therefore have the controlling vote, this is unlikely. This is because:

- The shareholdings are relatively dispersed
- The other investors do not have a close relationship with one another
- Based on past practice, it is likely that at least one of the other investors will
 not attend the Annual General Meeting, thus giving Ashanti the majority of the
 voting rights.

Ashanti controls the board of directors, thus enabling it to make key operating decisions that will affect the profits and returns of Night.

All things considered, it would seem that Ashanti will control Night. Night should therefore be accounted for as a subsidiary from the acquisition date.

	Marks
i) (i) Discussion – 1 mark per point	3
Calculations	3
	6
(ii) Discussion – 1 mark per point	4
Calculations	4
	8
(m)	
(iii) Pro-rating	1
Intra-group	2
PURP	1
Depreciation	2
Sale to Spice – narrative	2
Sale to Spice – adjustment	1
	9
Control 1 month nor maint	7
Control – 1 mark per point	/
otal	30
, lai	30



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Key answer tips

Parts (a) (i) and (ii) require you to discuss the treatment of financial reporting issues. Keep an eye on the clock, otherwise you will not have enough time to make a decent attempt at the rest of the question.

Part (a) (iii) asks you to prepare the equity section of the statement of financial position. The easiest way to do this would be to use the standard workings for a consolidated statement of financial position (W1 - W5). Don't forget about the adjustments you have proposed in your answer to the earlier parts of the question. Show all your workings - this will enable you to score highly even if you make a few mistakes.

In part (b), you need to talk about the impact of NCI measurement on the calculation of goodwill arising on the acquisition date as well as the impact on the goodwill impairment review.

(a) (i) Loan to charity



Tutorial note

The loan is a financial instrument because Trailer has a contractual right to receive cash.

IFRS 9 Financial Instruments says that financial assets should be recognised initially at fair value. According to IFRS 13 Fair Value Measurement, this is the selling price of an asset in an orderly transaction between market participants.

Market rate loans attract interest of 6%, whereas the loan advanced to the charity only attracts interest at 3%. As such, the price paid by Trailer of \$50 million is not indicative of the asset's fair value. The fair value of the financial asset must therefore be determined. This can be achieved by calculating the present value of all future cash receipts using the prevailing market interest rate for a similar instrument.

Fair value of the financial asset

	Cash flows	Discount factor	Present value
	\$m		\$m
20X3	1.5	1/1.06	1.4
20X4	1.5	1/1.06 ²	1.3
20X5	51.5	$1/1.06^3$	43.3
			46.0

The financial asset should have been recognised at \$46 million rather than \$50 million. The \$4 million difference between the fair value of the asset and the amount of cash advanced should have been recognised as an expense in profit or loss.

The correcting entry is:

Dr Profit or loss \$4.0m

Cr Financial assets \$4.0m

The financial asset is then measured at amortised cost because, as per IFRS 9, Trailer intends to hold it the asset to maturity to collect the contractual cash flows. Interest is credited to profit or loss using the effective rate. Cash receipts reduce the carrying amount of the asset.

	interest		
1 June 20X2	credit (6%)	Cash received	31 May 20X3
\$m	\$m	\$m	\$m
46.0	2.8	(1.5)	47.3

The cash receipt has been correctly accounted for. The correcting entry should therefore be:

Dr Financial assets \$2.8m

Cr Profit or loss \$2.8m

(ii) Provision for restructuring



Tutorial note

Remember the criteria for recognising a provision. All three of the criteria must be met before a provision can be recognised.

According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* a provision is recognised if:

- there is an obligation from a past event
- an outflow of economic benefits is probable
- the outflow can be measured reliably.

The first plan has been communicated to those directly affected, creating a constructive obligation to incur expenditure on the restructuring.

IAS 37 says that costs can only be included in a restructuring provision if they result directly from, and are necessarily entailed by, a restructuring. This includes costs such as employee redundancy costs. Expenses that relate to ongoing activities, such as relocation and retraining, are excluded. With regard to the first plan, a provision should be recognised for the redundancy costs of \$14 million.

The adjustment required is:

Dr Profit or loss \$14m

Cr Provisions \$14m

In contrast, Trailer should not recognise a provision for the finance and IT department's re-organisation. The re-organisation is not due to start for two years. External parties are unlikely to have a valid expectation that management is committed to the re-organisation as the time frame allows significant opportunities for management to change the details of the plan or even to decide not to proceed with it. Additionally, identification of the staff that will lose their jobs is not sufficiently detailed to support the recognising of a redundancy provision.

(iii) Extract from consolidated Statement of Financial Position at 31 May 20X3

	\$m
Equity attributable to owners of parent	
Share capital	1,750.0
Retained earnings (W5)	1,209.6
Other components of equity (W5)	140.0
	3,099.6
Non-controlling interest (W4)	833.2
Total equity	3,932.8

Workings

(W1) Group structure



(W2) Net assets



Tutorial note

If you are told the fair value of the net assets of the subsidiary at acquisition then you can calculate the fair value adjustments using a balancing figure approach.

	Acq'n date	Rep date
	\$m	\$m
Share capital	1,210	1,210
Other components	55	80
Retained earnings	650	930
Fair value adjustment – plant (bal. fig)	35	35
Depreciation (\$35m/7)		(5)
	1,950	2,250

Of the \$300 million (\$2,250m - \$1,950m) post-acquisition net asset movement, \$25 million (\$80m - \$55m) relates to other components of equity and \$275 million (\$300m - \$25m) relates to retained earnings.

(W3) Goodwill



Tutorial note

Goodwill needs to be calculated so that an impairment review can be performed.

	\$m
Fair value of consideration	1,250
NCI at acquisition (40% × \$1,950m)	780
Fair value of identifiable net assets acquired (W2)	(1,950)
Goodwill at acquisition	80

(W4) Non-controlling interest



Tutorial note

There are easy marks available here as long as you know your standard workings.

	\$m
NCI in Park at acquisition (W3)	780
NCI % of post-acquisition net assets	120
(40% × \$300m (W2))	
Impairment of other assets ($40\% \times $167m$ (W6))	(66.8)
	833.2

(W5) Reserves

Retained earnings



Tutorial note

Any adjustments to the statement of profit or loss will impact retained earnings.

	\$m
Trailer	1,240
Park: 60% × \$275m (W2)	165
Impairment of goodwill (W6)	(80)
Impairment of other assets (60% × \$167m (W6))	(100.2)
Financial asset write down (part a (i))	(4.0)
Interest credit (part a (i))	2.8
Restructuring provision (part a (ii)	(14)
	1,209.6

Other components of equity

	\$m
Trailer	125
Park: 60% × \$25m (W2)	15
	140

(W6) Impairment of Park



Tutorial note

In note 2 of the question, we are told the recoverable amount of the net assets of Park. We therefore need to compare this to the carrying amount of Park's net assets.

Remember that goodwill has been calculated using the proportionate basis. This means that, when performing an impairment review, the goodwill must be grossed up to include the NCI's interest.

	\$m	\$m
Goodwill (W3)	80	
Notional NCI (\$80m × 40/60)	53.3	
Total notional goodwill		133.3
Net assets at reporting date (W2)		2,250
Total carrying amount of assets		2,383.3
Recoverable amount		(2,083.0)
Impairment		300.3

The impairment is firstly allocated to the total notional goodwill of \$133.3m. However, only 60% of the total notional goodwill has been recognised in the statements and therefore only 60% (\$80m) of the impairment is accounted for. This expense is all attributable to the owners of Trailer.

The remaining impairment of \$167m (\$300.3m - \$133.3m) is allocated against the other assets of Park in proportion to their carrying amounts. This impairment loss is attributable to the owners of the Trailer and the NCI based on their respective shareholdings.

(b) Impact of measuring the NCI at air value



Tutorial note

When calculating goodwill in this part of the question, you will not be penalised for any mistakes that you made in part (a).

Remember that goodwill calculated under the fair value method **does not** need grossing up when performing an impairment review.

Goodwill calculation

Fair value of consideration Fair value of NCI Fair value of identifiable net assets acquired (W2)	\$m 1,250 800 (1,950)
Goodwill at acquisition	100
Goodwill impairment review	
	\$m
Goodwill	100
Net assets at reporting date (W2)	2,250
Total carrying amount	2,350
Recoverable amount	(2,083)
Impairment	267
Allocated to:	
Goodwill	100
Other assets	167
Total	267

Under the previous method used by Trailer, the NCI was recognised at its share of the subsidiary's net assets and so did not include any goodwill. The full goodwill method means that non-controlling interest and goodwill are both increased by the goodwill that relates to the non-controlling interest.

In the case of Park, measuring the NCI at its fair value increases the goodwill arising at acquisition from \$80 million to \$100 million. The figure used for NCI under the proportionate method of \$780m has also increased by \$20 million, to \$800m at 1 June 20X2.

The full goodwill method increases reported net assets, and so any impairment of goodwill will be greater. Thus in the case of Park, the impairment of goodwill will be \$100m. This will be charged \$60 million to retained earnings and \$40 million to the NCI. Under both methods, the impairment of the other assets is \$167 million, which is split between retained earnings and the NCI.

Although measuring non-controlling interest at fair value may prove difficult, goodwill impairment testing is easier under full goodwill. This is because there is no need to gross up goodwill.

		Marking scheme	
			Marks
(a)	(i) Discus	ssion – 1 mark per point	3
	Calcul	lations	3
			6
	(ii) Discus	ssion – 1 mark per point	5
	. ,		
	(iii) Share	capital	1
	NCI		2
	Retair	ned earnings	4
		alue adjustment	1
		will calculation	1
	Good	will impairment	2
		components of equity	1
			ļ
			12
(b)	NCI discussi	on – 1 mark per point	4
	Goodwill cal		1
	mpairment	calculation	2
			7
Total			30



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Key answer tips

Read the question carefully and you should be able to find several figures that you can put straight into your cash flow extracts (e.g. the associate's profits, the service cost component, and depreciation). Prioritise these quick, easy marks - they are essential to pass the exam.

(a) (i) Weston Group Statement of cash flows for year ended 31 January 20X6

	\$m
Cash flow from operating activities	
Profit before tax (W1)	189
Associate's profits	(16)
Service cost component	11
Depreciation	20
Impairment of goodwill (W5)	6
Cash contributions to pension scheme	(19)
Movements in working capital	
Increase in trade and other payables	
(\$36m - \$41m + \$10m)	5
Increase in trade and other receivables	(25)
(\$106m - \$104m + \$23m)	(25)
Decrease in inventories (\$108m – \$165m + \$38m)	19
Cash generated from operations	190
Income taxes paid (W7)	(81)
	109
Cash flows from investing activities	
Purchase of property, plant and equipment (W8)	(84)
Dividends received from associate (W6)	4
Purchase of associate (W6)	(90)
Net proceeds on disposal of Northern (W2)	87.4
	(82.6)

Workings

(W1) Profit



Tutorial note

You need to use the profit before tax from both continuing and discontinued operations.

Total profit before tax is:

	\$m
Profit before tax – continuing operations	183
Profit before tax – discontinued operations	6
	189

(W2) Proceeds on disposal of Northern



Tutorial note

The question tells you the loss on the disposal of the subsidiary and gives you enough information to calculate the goodwill, net assets and non-controlling interest at the disposal date. You then need to work backwards, to deduce the cash proceeds received from the subsidiary disposal.

	\$m
Cash proceeds from sale (bal. fig.)	85.4
Goodwill at disposal (W3)	(9)
Fair value of net assets at disposal (W4)	(129)
Non-controlling interest at disposal (W4)	23.6
Loss on disposal (per question)	(29)

The net cash impact of the disposal is therefore \$87.4 million (\$85.4m proceeds + \$2m overdraft disposed).

(W3) Goodwill - Northern



Tutorial note

Goodwill calculations are a source of easy marks.

	\$m
Consideration	132
Fair value of non-controlling interest	28
	160
Identifiable net assets at acquisition	(124)
Goodwill on acquisition	36
Impairment of goodwill (75%)	(27)
Carrying amount of goodwill at disposal	9

(W4) Net assets and NCI at disposal



Tutorial note

The question gives you the carrying amount of the net assets in Northern's individual financial statements. However, this will not include the fair value uplift that arises on consolidation, or the deferred tax on this uplift.

The carrying amount of the property, plant and equipment at disposal will be \$80m, as per the question, plus \$16 million fair value uplift less 4/8 depreciation. This amounts to \$88 million.

The deferred tax liability recorded on the fair value uplift would have been \$4 million (25% \times \$16m). This will have been released in line with the extra depreciation, so the carrying amount at disposal will be only \$2 million (\$4m - (\$4m \times 4/8)). The carrying amount of the entire deferred tax liability at disposal is therefore \$8m (\$6m per question + \$2m above).

The revised carrying amounts at disposal are:

	\$m
Property, plant and equipment	88
Inventory	38
Trade receivables	23
Trade and other payables	(10)
Deferred tax	(8)
Bank overdraft	(2)
	129
The non-controlling interest in Northern at disposal will be:	
	\$m
Non-controlling interest at acquisition	28
NCI share of post-acquisition net assets	
(20% × (\$129m – \$124m))	1
NCI share of goodwill impairment (20% \times \$27m) (W3)	(5.4)
	23.6

(W5) Goodwill



Tutorial note

Reconcile goodwill year-on-year to identify the impairment charge. This needs to be added back to profit when calculating cash generated from operations.

	\$m
Balance at 1 February 20X5	19
Disposal of subsidiary (W3)	(9)
Impairment (bal. fig.)	(6)
Balance at 31 January 20X6	4

(W6) Associate



Tutorial note

Lots of students forget that dividends received from an associate reduce the carrying amount of the group's investment.

	\$m
Balance at 1 February 20X5	-
Share of associate profit	16
Dividend received (\$10m × 40%)	(4)
Cost of acquisition (bal. fig.)	90
Balance at 31 January 20X6	102

(W7) Taxation



Tutorial note

Deferred tax can be charged to profit or loss, or to other comprehensive income. Don't forget the tax charge relating to the discontinued operation (note (ii) in the question).

	\$m
Balance at 1 February 20X5 (\$15m + \$92m)	107
Charge for year – continuing	40
Charge for year – discontinued	2
Deferred tax at disposal (W4)	(8)
Deferred tax on remeasurement gain (25% \times \$4m)	1
Cash paid (bal. fig.)	(81)
Balance at 31 January 20X6 (\$14m + \$47m)	61



Tutorial note

Since the actuarial gain of \$4m would be recorded in other comprehensive income, the deferred tax on the actuarial gain of \$1m (25% \times \$4m) will also be in other comprehensive income. Any remaining movement in the deferred tax on the pension will be included within the charge to profit or loss for the year.

(W8) Property, plant and equipment

	\$m
Balance at 1 February 20X5	413
Disposal of subsidiary (W4)	(88)
Depreciation charge	(20)
Cash additions (bal. fig.)	84
Balance at 31 January 20X6	389

(ii) The indirect method

IAS 7 Statement of Cash Flows states that the indirect method of calculating cash generated from operations involves adjusting the profit (or loss) for the period for the effects of:

- changes in inventories, payables and receivables
- non-cash items
- items which relate to investing or financing.

With regards to Weston:

 Associate's profits – undistributed profits of an associate are not a cash flow and so must be deducted from the group's profit before tax. Moreover, an associate is a type of investment rather than a part of the entity's operating activities and so any cash flows with associate entities are reported within 'cash flows from investing activities'.

- Service cost, depreciation and impairment these are non-cash expenses and so are eliminated by adding them back to profit.
- Movements in working capital businesses buy and sell goods on credit, but only cash receipts and cash payments should be reported in the statement of cash flows. Adjusting for the movement in working capital items eliminates the impact of accruals accounting. In the current year. Some of the year-on-year movement in working capital relates to the disposal of Northern, rather than because of cash flows with customers and suppliers, and so the effect of this disposal has been eliminated.

(b) Investment in Abuelo Co



Tutorial note

This part of the question tests a foreign associate. This is a new addition to the 22/23 syllabus. Make sure you understand these concepts as, historically, the examiners have included scenarios based upon the new topics at the earliest possible opportunity.

Weston Group's proposed 30% investment in Abuelo Co will cause Weston to exert significant influence on Abuelo Co. Therefore, Abuelo will be accounted for as an associate, using equity accounting.

Equity accounting recognises an 'Investment in associate' under Non-current assets within the statement of financial position. This consists of the consideration paid, plus the parent's share of any post-acquisition movement in the net assets of the associate. No consolidation of the assets or liabilities of the associate occurs as no control is exerted.

As Abuelo Co is a foreign currency associate, the investment in associate must be translated at the closing rate for inclusion within the group accounts. This may create foreign currency gains or losses on translation that will be recorded within group equity and other comprehensive income. The investment in associate line is calculated as \$3.4m (see W1) for inclusion within the Weston Group non-current assets as at 31 January 20X7.

The statement of profit or loss and other comprehensive income includes, in separate lines, the parent's share of the associate's profit after tax (above group profit before tax) and the associate's other comprehensive income (within group OCI).

The share of Abuelo Co's profits would be translated at the average rate for inclusion in the group accounts. Thus a share of associate's profit figure of $10\% \times (40 \times 6/12)$, would be recorded above group profit before tax.

The group OCI would include the annual foreign currency loss of \$0.6m (see W1) arising from the translation of the foreign currency associate. This would also be debited to a translation reserve within the group statement of financial position (located within the equity section). Abuelo Co does not anticipate recording any items of OCI for the year ended 31 January 20X7 so no share of associate's OCI is required.

Working	
---------	--

-	Dinars m	Exchange rate	\$m
Cost of associate			
– Cash	6.0	6	1.0
 Shares (1m × \$2m) translated at 6 dinars (HR) 	12.0	6	2.0
Share of profit $(30\% \times (40 \text{m dinars} \times 6/12))$	6.0	5.8	1.0
Exchange gain		bal. fig	(0.6)
Closing investment in associate	24.0	7	3.4

		Marking scheme	
			Marks
(a)	(i)	Cash flows from operating activities	
		Profit	1
		Associate's profit	1
		Pension scheme service cost	1
		Depreciation	1
		Goodwill impairment	1
		Working capital movements	3
		Tax paid	2
		Pension contributions	1
		Cash flows from investing activities	
		Property, plant and equipment	1
		Associate dividend	1
		Purchase of associate	1
		Disposal of Northern	4
			18
	(ii)	Indirect method	6
	(")	munice method	
(b)	Fore	eign currency associate	
. ,	SOFI	-	3
	P/L		1
	OCI		2
Total			30

15



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Key answer tips

Remember to allocate your time carefully when attempting question 1 in the SBR exam. It would be very easy to get bogged down in a particular issue or adjustment and to then run out of time. Spend your time on the areas of the question that you are most confident with.

(a) Hulty



Tutorial note

Consideration transferred in a business combination and the identifiable net assets of the subsidiary at the acquisition date should both be measured at fair value. If you struggle to think about the double entries required for these adjustments then think about how you would process them through the standard consolidation workings and what impact this would have on the SFP balances.

Deferred consideration

IFRS 3 Business Combinations says that the consideration transferred to achieve control over another business must be measured at fair value. Deferred consideration should be measured at its present value.

The present value of the deferred consideration as at 1 December 20X3 was \$41.3 million ($$50m \times 1/1.10^2$). Goodwill should be increased by this amount and a corresponding liability recognised. The correcting entry is:

Dr Goodwill \$41.3m

Cr Liabilities \$41.3m



Tutorial note

Don't forget to unwind the discount on the liability.

Interest on the liability should be charged to profit or loss in the year. This amounts to \$4.1 million (\$41.3m × 10%). The entry to record this in the consolidated statement of financial position is:

Dr Retained earnings \$4.1m

Cr Liabilities \$4.1m

Franchise right

IFRS 3 *Business Combinations* says that the identifiable net assets of a subsidiary should be measured at fair value at the acquisition date.

The fair value of the identifiable net assets exceeds their carrying amounts by \$20 million (\$980m - \$960m). This relates to an unrecognised intangible franchise right that must be recognised in the consolidated financial statements as at the acquisition date. This adjustment reduces the amount of goodwill recognised. The correcting adjustment is:

Dr Intangible asset – franchise right \$20m

Cr Goodwill \$20m

The intangible asset should be amortised over its remaining useful life. The current year charge that needs to be recorded in consolidated profit or loss is \$5 million (\$20m/4 years). The franchise right is an asset held by the subsidiary, so the charge in profit or loss should be allocated between the owners of the parent company and the non-controlling interest based on their respective shareholdings. The entry required to record this in the consolidated statement of financial position is:

Dr Retained earnings ($\$5m \times 80\%$) \$4mDr NCI ($\$5m \times 20\%$) \$1mCr Intangible asset – franchise right \$5m

Total goodwill arising on Hulty

Total goodwill arising on the acquisition of Hulty is therefore \$61.3 million (\$40m draft + \$41.3m – \$20m).

(b) Margy

Step acquisition

Joey has achieved control over Margy in stages. On the date that control was achieved the previous shareholding should been included in the goodwill calculation at its fair value. Any gain or loss on revaluing this shareholding to fair value is recorded in the consolidated statement of profit or loss (or in other comprehensive income if the previously held shares were measured at fair value through other comprehensive income).

The equity accounted investment in Margy of \$700 million should therefore have been eliminated and included in the goodwill calculation at its fair value of \$705 million. A \$5 million gain would arise in consolidated profit or loss.

This adjustment means that the gain on bargain purchase of \$655 million is eliminated. The adjusting entry required in the statement of financial position is:

Dr Retained earnings (to remove gain on bargain purchase) \$655m

Dr Goodwill (\$705m - \$655m) \$50m

Cr Investment in associate \$700m

Cr Retained earnings (gain on step acquisition) \$5m

Building adjustment

During the measurement period, the acquirer must retrospectively adjust the amounts recognised at the acquisition date if further facts and information are obtained. The measurement period ends 12 months after the acquisition date.

The revision of the building's fair value at the acquisition date was determined within 12 months of the business combination so it must therefore be adjusted for as at the acquisition date. This will reduce the amount of property, plant and equipment (PPE) in the consolidated statement of financial position and will increase the goodwill arising on the acquisition of Margy. The adjustment required is:

Dr Goodwill \$40m

Cr PPE \$40m

If the building is worth less than originally estimated then it increases the risk that Joey overpaid for Margy and therefore that goodwill might be impaired. However, no information is provided about this.



Tutorial note

It is common in exams to have to charge depreciation on a fair value uplift. However, if a building was over-valued as at the acquisition date then it is likely that the depreciation subsequently charged is also too high.

The property, plant and equipment has been included in the consolidated financial statements at \$200 million, rather than \$160 million, and so too much depreciation will have been charged. Depreciation of \$2 million (\$40m/20 years) must be removed from consolidated profit or loss. The PPE is held by a subsidiary and so this adjustment must be allocated to the owners of the parent and the non-controlling interest based on their respective shareholdings. The adjustment required in the consolidated statement of financial position is:

Dr PPE \$2m

Cr Retained earnings ($$2m \times 70\%$) \$1.4m

 $Cr NCI (\$2m \times 30\%)$ \$0.6m

Total goodwill arising on Margy

Total goodwill arising on the acquisition of Margy is therefore \$90 million (\$50m + \$40m).

(c) Joint arrangement



Tutorial note

A joint arrangement is an arrangement over which two or more parties have joint control. Remember that joint arrangements may take the form of joint operations or joint ventures. A joint venture, which normally involves the establishment of a separate entity, is accounted for using the equity method.

For the period to 31 May 20X4, the requirement for unanimous key strategic decisions means this is a joint arrangement. Since there is no legal entity, it would be classified as a joint operation. Joey should therefore account for its direct rights to the underlying results and assets.

Up until 31 May 20X4, the joint operation had the following results:

	\$m
Revenue (5m \times 6/12)	2.5
Cost of sales $(2m \times 6/12)$	(1.0)
Gross profit	1.5
The amount that belongs to CP is therefore:	\$m
10% × Sales (10% × 2.5m)	0.25
30% of gross profit 30% × \$1.5m)	0.45
Amount due to CP	0.7

Joey has recorded all of the sales proceeds and costs for the six month period, hence recording a profit of \$1.5 million. Joey's profits must therefore be reduced by \$0.7 million, and a payable to CP recorded for the same amount. The adjustment required is:

Dr Profit or loss	\$0.7m
Cr Accounts payable CP	\$0.7m



Tutorial note

The question requires you to 'discuss'. Easier marks are available for the narrative part of your answer.

From 1 June 20X4, Joey has a share of the net assets of the joint arrangement rather than direct rights. This means that the joint arrangement would be classified as a joint venture and must be accounted for in the consolidated financial statements using the equity method.

Joey has accounted for all proceeds and costs of the joint venture. This should be removed from its statement of profit or loss and a payable recorded to transfer this back to JCP

Dr Profit or loss \$1.5 m

Cr Payable to JCP \$1.5 m

Joey should then equity-for its share of JCP's profit of \$0.75 million ($\$1.5m \times 50\%$). This will be recorded in profit or loss and recognised as an investment in the statement of financial position.

Dr Investment in joint venture \$0.75 m

Cr Profit or loss \$0.75 m

(d) Debt and equity



Tutorial note

This is a very common exam requirement. You must memorise the definition of a financial liability.

IAS 32 Financial Instruments: Presentation says that a financial liability is a contractual obligation to deliver either cash or another financial asset to the holder. Equity is any contract which evidences a residual interest in the entity's assets after deducting all of its liabilities.

However, a contract may involve the delivery of the entity's own equity instruments. A contract which will be settled by the entity delivering a fixed number of its own equity instruments in exchange for cash or another financial asset is an equity instrument. If there is any variability in the number of own equity instruments to be delivered then the contract is a financial liability.

B shares

The B shares should be classified as equity because there is no contractual obligation to pay the dividends or to redeem the instrument. Dividends can only be paid on the B shares if dividends have been declared on the A shares. However, there is no contractual obligation to declare A share dividends.

Share options

The classification of the share options is dependent on whether there is variability in the number of equity shares delivered. Joey will settle the contract by issuing a fixed number of its own equity instruments in exchange for cash, so the share options would be classified as an equity instrument.

Marking scheme		
		Marks
(a)	Hulty – 1 mark per point	9
(b)	Margy – 1 mark per point	9
(c)	CP – 1 mark per point	8
(d)	IAS 32 classifications	4
Total		30

16



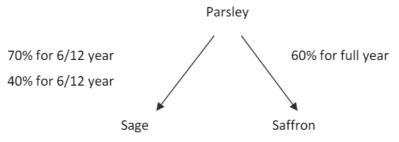
PARSLEY Walk in the footsteps of a top tutor



Key answer tips

Part (a) focusses on group accounting issues. Parsley lost control of Sage during the year. Sage is therefore consolidated until the disposal date and a profit or loss on disposal must be calculated. Saffron is an overseas subsidiary, which must be translated into the group's presentation currency. Exchange differences on the retranslation of Saffron's opening net assets, profit and goodwill are recorded in other comprehensive income.

(a) Group structure



(i) Sage



Tutorial note

Memorise the pro-forma for calculating the profit or loss arising on the disposal of a subsidiary. This can be worth a lot of marks in the exam.

Parsley lost control over Sage halfway through the year. This means that Parsley must consolidate the line-by-line results of Sage for the first 6 months of the year.

Sage made a profit for the year of \$6 million, of which Parsley will consolidate \$3 million (\$6 million \times 6/12). Of this, \$2.1 million (\$3 million \times 70%) is attributable to the equity owners of the Parsley group and the remaining \$0.9 million is attributable to the non-controlling interest.

A profit or loss on the disposal of Sage must be reported in the consolidated statement of profit or loss.

This is calculated as follows:		
	\$m	\$m
Proceeds from disposal	6.5	
Fair value of interest retained	9.5	
		16.0
Goodwill disposed:		
Consideration	6.0	
NCI at acquisition (\$5m × 30%)	1.5	
Net assets at acquisition	(5.0)	
Goodwill at disposal		(2.5)
Net assets at disposal:	1.0	
Share capital	1.0	
Retained earnings bfd	9.0	
Profit to disposal date ($$6m \times 6/12$)	3.0	
Net assets at disposal		(13.0)
Net assets at disposal		(13.0)
NCI at disposal:		
NCI at acquisition	1.5	
NCI % of post-acquisition net assets		
(30% × (\$13m – \$5m))	2.4	
		3.9
Profit on disposal		4.4
Tront on disposal		4.4

After the share sale, Parsley retains significant influence over Sage. This means that Sage is an associate for the final six months of the year and must be accounted for using the equity method. The group will show its share of the associate's profit as a single line in the consolidated statement of profit or loss. This amounts to $$1.2 \text{ million} ($6m \times 6/12 \times 40\%)$.

(ii) Saffron

Profit or loss

IFRS 3 Business Combinations says that the identifiable net assets of a subsidiary should be consolidated at fair value. It would seem that Saffron has a brand that is unrecognised in its individual financial statements but which must be consolidated at its fair value.

The fair value of this brand is calculated as follows:

	FRm
Fair value of net assets	70
Carrying amount of net assets	(60)
Fair value of brand	10

Amortisation must be charged on the brand. In the current period, this will be FR2 million (FR10m/5 years).

Saffron is an overseas subsidiary. Its results, including the above amortisation adjustment, must be translated for inclusion in the consolidated statement of profit or loss and other comprehensive income at the average rate. The results of Saffron will then be consolidated line-by-line. The net impact on consolidated profit will be \$6.1 million ((FR30 per P/L – FR2 amortisation)/4.6)). Of this \$3.7 million (\$6.1m \times 60%) is attributable to the equity owners of the parent. The remaining \$2.4 million is attributable to the non-controlling interest.

Goodwill impairment and foreign exchange



Tutorial note

Calculate goodwill in the subsidiary's currency and then translate it at the closing rate. The foreign exchange gain or loss is recorded in other comprehensive income, as an item that may be reclassified to profit or loss in the future.

The goodwill of Saffron is calculated as follows:

	FRm
Cost of acquisition	71
FV of NCI at acquisition	29
	100
Less FV net assets at acquisition	(70)
Goodwill at acquisition	30
Impairment	(4)
Goodwill at reporting date	26

Goodwill is translated at the reporting date at the closing rate. This gives rise to a foreign exchange gain, calculated below:

FX gain on retranslation	FRm	Rate	\$m
Acquisition	30	5.0	6.0
Impairment	(4)	4.6	(0.9)
FX gain on retranslation		Bal fig	1.4
Rep date	26	4.0	6.5

The impairment of \$0.9 million is recorded in profit or loss. Of this, \$0.5 million ($$0.9m \times 60\%$) is attributable to the equity owners of the parent. The remaining \$0.4 million is attributable to the non-controlling interest.

The gain of \$1.4 million is recorded in other comprehensive income. The forex gain attributable to the equity owners of the parent is \$0.8 million ($$1.4m \times 60\%$) and the remaining \$0.6 million is attributable to the non-controlling interest.

Foreign exchange gain on opening net assets and profit

A foreign exchange gain arises on the translation of Saffron's opening net assets and profit:

	FRm	Rate	\$m
Opening net assets	70	5.0	14.0
Profit			
(FR30m – FR2m (W1))	28	4.6	6.1
FX gain on retranslation		Bal fig	4.4
Rep date	98	4.0	24.5

The gain of \$4.4 million is recorded in other comprehensive income. The forex gain attributable to the equity owners of the parent is \$2.6 million ($$4.4m \times 60\%$) and the remaining \$1.8 million is attributable to the non-controlling interest.

(iii) Lease



Tutorial note

To determine the accounting entries in the second year of the lease you will need to determine the carrying amounts of the lease liability and right-of-use asset at the end of the first year.

The year ended 30 April 20X3

IFRS 16 *Leases* says that lease liabilities are recognised at the present value of payments yet to be made. This includes fixed lease payments, as well as variable payments based on the relevant index or rate at the start of the lease. The liability is reduced by cash payments. Interest on the liability increases its carrying amount and is charged to profit or loss.

A right-of-use asset is recognised at the value of the initial lease liability plus payments made before or at commencement and initial direct costs. Assuming the cost model is chosen, the asset is depreciated over the lower of the lease term and its remaining useful economic life.

In the prior year, the right of use asset would have been recognised at \$5 million (\$3.8m + \$1.2m). The depreciation charge in the prior year would have been \$1 million (\$5m/5 years), and the carrying amount of the asset at the end of the prior year was, therefore, \$4 million.

The lease liability would have been recorded at \$3.8 million. Interest of \$0.38 million ($$3.8m \times 10\%$) would have been charged to profit or loss. As such, the liability at 30 April 20X3 was \$4.18 million (\$3.8m + \$0.38m).

The year ended 30 April 20X4



Tutorial note

Remember that you are asked to provide an 'explanation'. Calculations and double entries are not enough to score a high mark.

If changes to lease payments occur then the liability must be recalculated and adjusted. A corresponding entry is made against the carrying amount of the right-of-use asset.

Based on inflation for the last 12 months, the lease payments now due each year are \$1.3 million (\$1.2m \times 108%).

The revised liability is calculated as follows:

	Cash (\$m)	Disc.	PV (\$m)
1/5/20X3	1.3	1	1.30
1/5/20X4	1.3	$1/1.10^1$	1.18
1/5/20X5	1.3	$1/1.10^2$	1.07
1/5/20X6	1.3	$1/1.10^3$	0.98
Revised liability			4.53

The lease liability must be increased from \$4.18 million to \$4.53 million. The entry required is:

Dr Right-of-use asset	\$0.35m
Cr Lease liability	\$0.35m

After this adjustment, the right-of use asset is held at \$4.35 million (\$4m + \$0.35m). Depreciation for the year ended 30 April 20X4 is \$1.09 million (\$4.35m/4 years).

Dr Depreciation expense \$1.09m

Cr Right-of-use asset \$1.09m

The carrying amount of the right-of use asset at the year-end is \$3.26 million (\$4.35m - \$1.09m).

The current year cash repayment has been incorrectly charged to profit or loss.

Dr Lease liability \$1.3m

Cr Cost of sales \$1.3m

Interest on the outstanding lease liability is 0.32 million ((4.53m – 1.3m) × 10%).

Dr Finance costs \$0.32m

Cr Lease liability \$0.32m

The carrying amount of the lease liability at the year-end is \$3.55 million (\$4.53m - \$1.3m + \$0.32m).

- **(b)** IAS 24 *Related Party Disclosures* states that a person or a close member of their family is related to the reporting entity if that person:
 - has control, joint control or significant influence over the reporting entity
 - is a member of key management personnel of the reporting entity or its parent.

The main circumstances that lead to an entity being related to the reporting entity are as follows:

- the entity and the reporting entity are members of the same group
- one entity is an associate or joint venture of the other
- both entities are joint ventures of the same third party
- the entity is controlled or jointly controlled by a person who is a related party of the reporting entity.

In the absence of related party disclosures, users of financial statements would assume that an entity has acted independently and in its own best interests. Most importantly, they would assume that all transactions have been entered into willingly and at arm's length (i.e. on normal commercial terms at fair value). Where related party relationships and transactions exist, this assumption may not be justified.

Related party relationships and transactions may distort financial position and performance, both favourably and unfavourably. The most obvious example of this type of transaction would be the sale of goods from one party to another on non-commercial terms.

It is a common misapprehension that related party transactions need only be disclosed if they are not on market terms. This is not the case. For example, a parent may instruct all members of its group to buy certain products or services (on commercial terms) from one of its subsidiaries. If the parent were to sell the subsidiary, it would be important for the prospective buyer to be aware that the related party transactions would probably not occur in the future.

Even where there have been no related party transactions, it is still important for some related party relationships to be disclosed. A subsidiary may obtain custom, receive favourable credit ratings, and benefit from a superior management team simply by being a part of a well-respected group. As such, an entity must always disclose information about its parent.

Marking scheme		
		Marks
(a)	(i) Sage – 1 mark per point	8
	(ii) Saffron – 1 mark per point	8
	(iii) Lease – 1 mark per point	8
(b)	Related parties – 1 mark per point	6
Total		30

17



MARCHANT Walk in the footsteps of a top tutor



Key answer tips

When producing a consolidated statement of profit or loss and other comprehensive income it is important to understand the group structure. Marchant disposed of shares in Nathan but did not lose control. Therefore, Nathan's incomes and expenses must be consolidated for the full year and no profit or loss on disposal is recorded in the group's financial statements. However, Marchant lost control over Option half way through the year. This means that Option's incomes and expenses must be consolidated for the first 6 months and then a profit on disposal calculated. Marchant retained significant influence over Option, so must account for the remaining holding using the equity method for the second half of the year.

Marchant Group: Statement of profit or loss and other comprehensive (a) (i) income for the year ended 30 April 20X4



Tutorial note

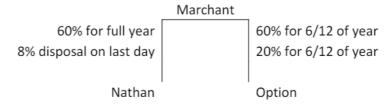
If a subsidiary has been disposed of during the year, remember to consolidate its income and expenses up to the disposal.

When producing a statement of profit or loss, you need to split profit and total comprehensive income for the period between the owners of the parent and the non-controlling interest.

Revenue (\$400 + \$115 + (6/12 × \$70) – \$12 (W6)) Cost of sales (\$312 + \$65 + (6/12 × \$36) – \$12 (W6))	\$m 538.0 (383.0)
Gross profit Other income ($\$21 + \$7 + (6/12 \times \$2) - \5.3 (W3)) Administrative costs ($\$15 + \$9 + (6/12 \times \$12)$) Other expenses ($\$35 + \$19 + (6/12 \times \$8) + \5 (W2))	155.0 23.7 (30.0) (63.0)
Operating profit Share of profits of associates $(20\% \times (6/12 \times \$15))$ Profit on disposal of subsidiary (W4) Finance costs $(\$5 + \$6 + (6/12 \times \$4))$ Finance income $(\$6 + \$5 + (6/12 \times \$8))$	85.7 1.5 22.0 (13.0) 15.0
Profit before tax Income tax expense ($$19 + $9 + (6/12 \times $5)$	111.2 (30.5)
Profit for the year	80.7
Other comprehensive income: Items which will not be reclassified to profit or loss Changes in revaluation surplus (\$10 + \$2 -\$5 (W3))	7.0
Total comprehensive income for the year	87.7
Profit attributable to: Owners of the parent (bal. fig.) Non-controlling interest (W7)	70.1
	80.7
Total comprehensive income attributable to: Owners of the parent (bal. fig.) Non-controlling interest (W7)	76.3 11.4
	87.7

Workings

(W1) Group structure



(W2) Nathan's goodwill



Tutorial note

Remember, impairments recorded against goodwill can never be reversed.

	\$m
Fair value of consideration	80
Fair value of non-controlling interest	45
	125
Fair value of identifiable net assets acquired	(110)
Goodwill at acquisition	15
Impairment (20%)	(3)
Goodwill	12

Goodwill has been increased to \$17 million (\$15m + \$2m). However, impairments recorded against goodwill are not allowed to be reversed. Therefore, \$5 million (\$17m - \$12m) must be charged to profit or loss to reduce goodwill to the correct amount of \$12 million.

(W3) Disposal of shares in Nathan



Tutorial note

Control over Nathan has not been lost. Therefore, no profit or loss on disposal should be recorded in the consolidated financial statements.

A profit on disposal will have been recorded in the individual accounts of Marchant, calculated as follows:

	\$m
Proceeds	18.0
Carrying amount of investment disposed (8/60 × \$95m)	(12.7)
Profit	5.3

This profit on disposal must be removed from other income. There will be no profit or loss on disposal in the consolidated financial statements because control over the subsidiary has not been lost.

The current year gain on the investment in Nathan of \$5 million (\$95m – \$90m) must also be removed from other comprehensive income.

(W4) Disposal of Option



Tutorial note

If control over an investment has been lost, a profit or loss on disposal must be calculated and included in the consolidated statement of profit or loss. This calculation is normally worth a lot of marks so it is important to learn the pro-forma.

As Marchant has sold a controlling interest in Option, a gain or loss on disposal should be calculated. Additionally, the results of Option should only be consolidated in the statement of profit or loss and other comprehensive income for the six months to 1 November 20X3. Thereafter Option should be accounted for using the equity method.

The gain recognised in profit or loss would be as follows:

	\$m	\$m
Fair value of consideration		50
Fair value of residual interest		40
		90
Less carrying amount of subsidiary:		
Net assets at disposal	90	
Goodwill at disposal (W5)	12	
Non-controlling interest at disposal	(34)	
		(68)
Gain on disposal to profit or loss		22

(W5) Goodwill of Option



Tutorial note

Goodwill calculations are a source of easy marks. Make sure that you know the pro-forma.

	\$m
Fair value of consideration	70
Fair value of non-controlling interest	28
Fair value of identifiable net assets acquired	(86)
Goodwill	12

(W6) Intra-group sale



Tutorial note

Intra-group trading must be eliminated from consolidated revenue and costs of sales. Any unrealised profits should also be eliminated by increasing cost of sales. However, if a loss is made on intra-group trading, it may suggest that the value of the goods have fallen and therefore that the loss is actually realised.

The loss on the sale of the inventory is not eliminated from group profit or loss. Because the sale is at fair value, the inventory value must have been impaired and therefore the loss on sale must remain realised. However, the revenue and cost of sales of \$12 million will be eliminated.

(W7) Profit and TCI attributable to the NCI



Tutorial note

When calculating the NCI's share of Nathan's profit and TCI, it is important to think about the date of the share disposal. The 8% holding of Nathan was not sold to the NCI until the very last day of the year. Therefore, when the profits and OCI of Nathan were earned, the NCI share was 40% rather than 48%.

	Nathan	Option
	\$m	\$m
Profit (6/12 Option)	19.0	7.5
× NCI % (40%)	7.6	3.0

The total profit attributable to the NCI is therefore \$10.6 million (\$7.6m + \$3.0m).

	Nathan	Option
	\$m	\$m
TCI (6/12 Option)	21.0	7.5
× NCI % (40%)	8.4	3.0

The TCI attributable to the NCI is therefore \$11.4\$ million (\$8.4m + \$3.0m).

(ii) Sale of shares in Nathan



Tutorial note

If control over an investment is retained, then a profit or loss on disposal is not included in the consolidated financial statements. Instead, equity is adjusted.

Note that part (ii) asks you to **explain** how the sale of the shares will be treated. Calculations are not enough to score full marks.

Once control has been achieved, transactions whereby the parent entity acquires further equity interests from non-controlling interests, or disposes of equity interests without losing control, are accounted for as equity transactions.

Therefore:

- the carrying amount of the non-controlling interests is adjusted to reflect the changes in its interest in the subsidiary
- any difference between the amount by which the non-controlling interests is adjusted and the fair value of the consideration paid or received is recognised directly in equity attributed to the owners of the parent; and
- there is no consequential adjustment to the carrying amount of goodwill, and no gain or loss is recognised in profit or loss or in other comprehensive income.

Sale of equity interest in Nathan

Fair value of consideration received	\$m 18
Increase in non-controlling interest (\$120m net assets + fair value adjustment of \$14m (see below) + \$12m goodwill) × 8%)	
	(11.7)
Positive movement in parent equity	6.3
The fair value adjustment at acquisition is calculated as follows:	
	\$m
Share capital	25
Retained earnings	65
Other components of equity	6
Fair value adjustment (bal. fig.)	14
Fair value of net assets	110

(b) Derecognition



Tutorial note

Start your answer by stating the de-recognition rules from IFRS 9. You would not be expected to know the same level as detail as is provided below.

Derecognition is required if either:

- the contractual rights to the cash flows from the financial asset have expired,
- the financial asset has been transferred, and the transfer of that asset is eligible for derecognition.

An asset is transferred if the entity has transferred the contractual rights to receive the cash flows.

Once an entity has determined that the asset has been transferred, it then determines whether or not it has transferred substantially all of the risks and rewards of ownership of the asset. If substantially all the risks and rewards have been transferred, the asset is derecognised. If substantially all the risks and rewards have been retained, derecognition of the asset is precluded.



Tutorial note

Now apply the rules that you have stated to the information in the scenario.

Marchant has transferred its rights to receive cash flows. However, it has guaranteed that it will compensate the bank up to \$3.6 million. As such, it has retained credit risk associated with the asset.

Additionally, Marchant would seem to have some late payment risk as it will be charged interest on amounts received over \$3.6 million.

It would seem that Marchant has not transferred substantially the risks associated with the receivable. Therefore the receivables of \$4 million should still be re-instated in the financial statements. Marchant should recognise a liability of \$3.6 million for the cash proceeds received and remove the charge of \$0.4 million from profit or loss.

Marking scheme		
		Marks
(a)	Consolidation	1
	Pro-rating of Option	1
	Intra-group trade	2
	Goodwill impairment adjustment	3
	Removal of gain on Nathan	2
	Removal of OCI gain	1
	Gain on disposal of Option	3
	Goodwill calculation for Option	1
	Associate	2
	NCI	2
	Sale of equity interest in Nathan	5
		23
(b)	IFRS 9 Financial Instruments derecognition – 1 mark per point	7
Total		30



ANGEL Walk in the footsteps of a top tutor



Key answer tips

Students generally dislike statements of cash flows. However, there are lots of easy marks available because many of the cash flows do not require any workings - find these in the question and slot them straight into your pro-forma. Think about whether the figures need brackets - you will lose marks if you get this wrong.

To answer part (b) it is essential to know the definition of a 'cash equivalent'. State this definition and then apply it to each of the two deposits in the question.

(a) Statement of cash flows for the year ended 30 November 20X3

Profit before tax	\$m 188
Adjustments to operating activities	
Finance costs	11
Associate's profit	(12)
Depreciation	29
Financial assets – profit on sale (\$40m – \$26m)	(14)
Profit on sale of PPE (\$63m – \$49m)	(14)
Impairment of goodwill and intangible assets (W2)	116.5
Retirement benefit expense (W6)	10
	314.5
Movements in working capital	
Decrease in trade receivables (\$125m – \$180m – \$3m)	58
Decrease in inventories (\$155m – \$190m – \$6m)	41
Decrease in trade payables (\$155m – \$361m – \$4m)	(210)
Cash generated from operations	203.5
Cash paid to retirement benefit scheme (W6)	(9)
Interest paid	(11)
Income taxes paid (W5)	(135.5)
Net cash generated by operating activities	48
Cash flows from investing activities	
Sale of financial assets	40
Purchase of financial assets	(57)
Purchase of property, plant and equipment (W1)	(66)
Purchase of subsidiary (\$30m – \$2m)	(28)
Proceeds from sale of property, plant and equipment	63
Dividend received from associate (W4)	3
Purchase of associate (W4)	(71)
Net cash flows used by investing activities	(116)
Cash flows from financing activities	
Proceeds from issue of shares (SOCIE)	225
Repayment of long-term borrowings (\$26m - \$57m)	(31)
Dividends paid (SOCIE)	(10)
Dividend paid to non-controlling interests (SOCIE)	(6)
Net cash generated by financing activities	178
Net increase in cash and cash equivalents	110
Cash and cash equivalents at beginning of period	355
Cash and cash equivalents at end of period	465

Workings

(W1) Property, plant and equipment

	\$m
Balance at 1 December 20X2	465
Disposals	(49)
Depreciation	(29)
Revaluation	8
Acquisition of sub	14
Purchase of PPE (bal. fig.)	66
Balance at 30 November 20X3	475

(W2) Impairments



Tutorial note

Reconcile the goodwill balance year-on-year to find the impairment charge. This is a non-cash expense so must be added back in the reconciliation between profit before tax and cash generated from operations.

	\$m
Opening balance at 1 December 20X2	120.0
Current year amount on subsidiary (W3)	11.5
Impairment (bal. fig.)	(26.5)
Closing balance at 30 November 20X3	105.0

Impairments of other intangibles amount to \$90m (\$240m - 150m).

Total impairments are therefore \$116.5m (\$90m + \$26.5m).

(W3) Purchase of subsidiary



Tutorial note

The subsidiary's identifiable net assets are consolidated at fair value. This means that their carrying amount in the consolidated financial statements differs from their tax base, normally giving rise to a deferred tax liability.

Calculation of deferred tax arising on acquisition:

	\$m
Fair values of Sweety's identifiable net assets excluding deferred tax Less tax base	20.0 (15.0)
Temporary difference arising on acquisition	5.0
Net deferred tax liability arising on acquisition (30% \times \$5m)	1.5
Calculation of goodwill: Purchase consideration Fair value of net assets (net of deferred tax) Deferred taxation	30.0 (20.0) 1.5
Goodwill arising on acquisition	11.5

(W4) Associate



Tutorial note

Associates are accounted for using the equity method.

nil
12
(3)
71
80

Therefore, cash paid for the investment is \$71 million, and the cash dividend received is \$3 million.

(W5) Taxation



Tutorial note

When calculating the tax paid during the year, include the opening and closing deferred tax balances in your workings. Also, remember that deferred tax charges may have been recorded in other comprehensive income.

	\$m
Balance at 1 December 20X2 (\$31m + \$138m)	169
Charge for year (P/L)	46
Deferred tax on acquisition (W3)	1.5
Tax on revaluation PPE	2
Tax on financial assets	1
Cash paid (bal. fig.)	(135.5)
Balance at 30 November 20X3 (\$35m + \$49m)	84

(W6) Retirement benefit



Tutorial note

The service cost component and net interest component are non-cash expenses. These must be added back to profit in the reconciliation between profit before tax and cash generated from operations.

	Şm
Opening balance at 1 December 20X2	74
Remeasurement component	4
Current year service cost plus interest	11
Contributions paid	(9)
Closing balance at 30 November 20X3	80

The \$11 million service cost and interest figure above includes the carrying amount of the subsidiary's defined benefit obligation at the acquisition date. Therefore, the actual expense is \$10m (\$11m - \$1m). This is added back in the reconciliation between profit before tax and cash generated from operations.

(b) Cash and cash equivalents comprise cash in hand and demand deposits, together with short-term, liquid investments which are readily convertible to a known amount of cash and which are subject to an insignificant risk of changes in value. IAS 7 Statement of Cash Flow does not define 'short term' but does state 'an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition'.

Consequently, equity or other investments which do not have a maturity date are normally excluded from cash equivalents.



Tutorial note

Remember to apply the definition of 'cash equivalents' to the scenario.

As regards the deposits, the following is the case:

- (i) Although the principal (\$3 million) will be recoverable with early withdrawal, the entity will lose all accumulated interest over the term, which seems to be a significant penalty. The cash is not needed to meet short-term cash commitments and so would not qualify as a cash equivalent.
- (ii) Although the deposit is stated to have a 12-month maturity period, it can be withdrawn with 21 days' notice. Although this incurs a penalty, the reduction in the rate of interest from 3% to 2% is unlikely to be considered significant and is in line with the bank's short-term deposit rate. The intention of management is to keep these funds available for short-term cash needs and so this deposit is likely to qualify as a cash equivalent.

Marking scheme		
		Marks
(a)	Finance costs	1
	Associate's profit	1
	Depreciation	1
	Profit on disposal of PPE/financial assets	1
	Impairment of intangibles	2
	Pension expense	1
	Working capital movements	3
	Cash paid to pension	1
	Interest paid	1
	Tax paid	2
	Sale and purchase of financial asset	1
	Purchase of PPE	2
	Purchase of subsidiary	1
	Proceeds from PPE disposal	1
	Dividend from associate	1
	Purchase of associate	1
	Proceeds from shares	1
	Borrowings	1
	Dividends paid	1
	Dividends paid to NCI	1
	Net movement in cash	1
		26
	Maximum	25
(b)	Cash and cash equivalents – 1 mark per point	5
. ,		
Total		30

19



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Key answer tips

This is a good question for testing your knowledge of a number of consolidation issues. In particular, this group uses both the share of net assets method and the fair value method to value the non-controlling interest at acquisition. This has important implications for subsequent goodwill impairments - goodwill calculated under the share of net asset method must be grossed up to include the non-controlling interest's share when performing an impairment review.

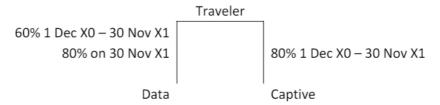
This question also involves the parent company increasing its shareholding in a subsidiary from 60% to 80%. Goodwill is calculated on the date that control is achieved and is not recalculated. Instead, this increase in the group's shareholding is accounted for in equity.

(a) Consolidated Statement of Financial Position at 30 November 20X1

	\$m
Assets:	
Non-current assets:	
Property, plant and equipment (W8)	1,845
Goodwill (W3)	69.2
Financial assets (\$108m + \$10m + \$20m)	138
Current assets (\$1,067m + \$781m + \$350m)	2,198
Total assets	4,250.2
Fauity and liabilities	
Equity and liabilities Equity attributable to owners of parent	
Share capital	1,120
Retained earnings (W5)	1,058
Other components of equity (W5)	91.7
	2,269.7
Non-controlling interest (W4)	343.5
	2,613.2
Total non-current liabilities (\$455m + \$323m + \$73m)	851.0
Current liabilities (\$274m + \$199m + \$313m)	786.0
Total liabilities	1,637.0
Total equity and liabilities	4,250.2

Workings

(W1) Group structure



(W2) Net assets



Tutorial note

The identifiable net assets of a subsidiary are consolidated at fair value. Make sure that fair value adjustments are processed through your net asset workings.

Data

	Acq'n date	Rep date
	\$m	\$m
Share capital	600	600
Retained earnings	299	442
Other Equity	26	37
Fair value adjustment – Land (bal. fig)	10	10
	935	1,089

Of the net asset movement of \$154 million (\$1,089m - \$935m), \$11 million (\$37m - \$26m) relates to other components of equity and the remaining \$143 million relates to retained earnings.

Captive

	Acq'n date	Rep date
	\$m	\$m
Share capital	390	390
Retained earnings	90	169
Other Equity	24	45
Fair value adjustment – Land (bal. fig)	22	22
	526	626

Of the net asset movement of \$100 million (\$626m - \$526m), \$21 million (\$45m - \$24m) relates to other components of equity and the remaining \$79 million relates to retained earnings.

(W3) Goodwill



Tutorial note

Pay attention to whether the NCI at acquisition is being measured at its share of the subsidiary's identifiable net assets or at fair value.

Remember that goodwill is calculated at the date control is achieved over another company. It is not recalculated for any further share purchases.

Data	
	\$m
Fair value of consideration for 60% interest	600
Fair value of non-controlling interest	395
Fair value of identifiable net assets acquired (W2)	(935)
Goodwill at acquisition	60
Impairment (W6)	(50)
Goodwill at reporting date	10
Captive	
	\$m
Fair value of consideration	541
NCI at acquisition (\$526 × 20%)	105.2
Less fair value of identifiable net assets (W2):	(526)
Goodwill	120.2
Impairment (W6)	(61)
	59.2

Total goodwill at the reporting date is \$69.2m (\$10 + \$59.2).

The assets transferred as part of the consideration need to be removed from non-current assets, and the gain on disposal needs to be calculated. The sale consideration of \$64 million has been recorded in profit. The carrying amount of the asset is \$56 million, giving a gain on disposal of \$8 million.

The adjustment required to arrive at the gain is:

Dr Retained earnings (W5) \$56m

Cr PPE (W8) \$56m

(W4) Non-controlling interest

	NCI in Data at acquisition (W3)	\$m 395
	NCI % of Data's post acquisition net assets	
	(40% × \$154m (W2))	61.6
	Reduction in NCI (W7)	(228.3)
	Impairment of Data goodwill (W6)	(10)
	NCI in Captive:	
	NCI in Captive at acquisition (W3)	105.2
	NCI % of Captive's post-acquisition net assets (20% × \$100m (W2))	20.0
		343.5
(W5)	Reserves	
	Retained earnings	
		\$m
	Traveler	1,066.0
	Sale of non-current asset (W3)	(56.0)
	Impairment of Data goodwill (W6)	(40)
	Impairment of Captive goodwill (W6)	(61)
	Post-acquisition retained earnings:	
	Data (60% × \$143m (W2))	85.8
	Captive (80% × \$79m (W2))	63.2
		1,058
	Other components of equity	
		\$m
	Traveler	60.0
	Data (60% × \$11m (W2))	6.6
	Captive (80% × \$21m (W2))	16.8
	Positive movement in equity (W7)	8.3
		91.7

(W6) Impairment of goodwill



Tutorial note

Pay close attention to whether the non-controlling interest has been valued using the share of net assets method or the fair value method.

If the share of net assets method has been used, then only the goodwill attributable to the parent has been calculated. When performing an impairment review, this goodwill must be notionally grossed up to include the NCl's share.

Data	
	\$m
Goodwill (W3)	60
Identifiable net assets (W2)	1,089
Total	1,149
Recoverable amount	(1,099)
Goodwill impairment	50

The goodwill impairment relating to Data will be split 80%/20% between the group and the NCI. Thus retained earnings will be debited with \$40 million (W5) and NCI with \$10 million (W4).



Tutorial note

It could be argued that a 60:40 allocation between group and NCI is also appropriate as this was how profits that arose in the year have been apportioned and the impairment is a loss that arose in the year, albeit calculated at the year end.

Captive		
	\$m	\$m
Goodwill (W3)	120.2	
Notional NCI (\$120.2 × 20/80)	30.1	
Total notional goodwill		150.3
Identifiable net assets (W2)		626.0
Total		776.3
Recoverable amount		(700.0)
Impairment		76.3

The impairment is allocated to the notional goodwill. However, only 80% of the notional goodwill has been recognised in the consolidated statements and so only 80% of the impairment is accounted for. This means that the goodwill impairment recognised is \$61m ($$76.3 \times 80\%$). This expense is all attributable to the group and therefore retained earnings (W5) must be debited with \$61m.

(W7) Increase in shareholding



Tutorial note

If the group increases its shareholding in a subsidiary, goodwill is not recalculated. Instead, this transaction is accounted for in equity. The difference between the cash paid and the decrease in the NCI is recorded in other components of equity.

	\$m	\$m
Fair value of consideration		220
NCI in Data at acquisition (W4)	395	
NCI % of Data's net assets movement (W4)	61.6	
NCI per share purchase	456.6	
Reduction in NCI (20/40 × \$456.6m)		228.3
D 111 11 11 11 11 11 11 11 11 11 11 11 1		
Positive movement in equity (W5)		8.3

(W8) Property, plant and equipment

	\$m
Traveler	439
Data	810
Captive	620
Increase in value of land – Data (W2)	10
Increase in value of land – Captive (W2)	22
Less disposal of asset (W3)	(56)
	1,845

(b) Disclosure of the impact of fair value uplifts

IAS 2 *Inventories* requires the carrying amount of inventories sold to be recognised as an expense in the period in which the related revenue is recognised. Cost of sales are costs previously included in the measurement of inventory which has now been sold plus unallocated production overheads and abnormal amounts of production costs of inventories.

IFRS 3 Business Combinations requires an acquirer to measure the identifiable assets acquired in a business combination at their fair values at the date of acquisition. Therefore, the carrying amount of the inventories originating from the acquisition of the subsidiary is their acquisition-date fair value. Consequently, the entire carrying amount of inventory, including the effects of the fair value step-up, should be presented as cost of sales.

IAS 1 *Presentation of Financial Statements* sets out minimum levels of required items in the financial statements by requiring certain items to be presented on the face of, or in the notes to, the financial statements and in other required disclosures.

IAS 1 provides little further guidance on the presentation of line items in financial statements, such as the level of detail or number of line items that should be presented in the financial statements. The absence of specific requirements arises from the fact that the guidance in IAS 1 relies on management's judgement about which additional line items, headings and subtotals:

- (a) are relevant to an understanding of the entity's financial position/ financial performance; and
- (b) should be presented in a manner which provides relevant, reliable, comparable and understandable information.

IAS 1 allows entities to include additional line items, amend descriptions and the ordering of items in order to explain the elements of financial performance due to various activities, which may differ in frequency and predictability.

Transactions like business combinations may have a significant impact on profit or loss and these transactions are not necessarily frequent or regular. However, the practice of presenting non-recurring items may be interpreted as a way to present 'extraordinary items' in the financial statements despite the fact that 'extraordinary items' are not allowed under IAS 1. It can also be argued that additional lines and subtotals, as permitted by IAS 1, may add complexity to the analysis of the financial statements, which may become difficult to understand if entities use sub-totals and additional headings to isolate the effects of non-recurring transactions from classes of expense or income.

To conclude, the cost of the inventories sold should be presented as a cost of sale and not split in the manner proposed by Traveler.

	Marking scheme	
		Marks
(a)	Property, plant and equipment	2
	Goodwill	3
	Other assets/liabilities	2
	Share capital	1
	Retained earnings	5
	Other components of equity	3
	Non-controlling interest	4
		23
(b)	Fair value adjustment disclosure – 1 mark per point	7
Total		30

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Key answer tips

This question involves consolidating an overseas subsidiary.

When consolidating a subsidiary with a different functional currency to that of the group, its assets and liabilities are translated at the closing exchange rate. Translation differences arise on goodwill and the opening net assets and profit of the subsidiary. Current year exchange differences are recorded in other comprehensive income. The cumulative exchange gains and losses are held in equity.

This question also involves the parent company increasing its shareholding in a subsidiary from 70% to 80%. This results in a decrease in the NCI holding from 30% to 20%, a decline of one third. Such transactions are accounted for within equity and no adjustments are made to goodwill.

(a) Rose plc

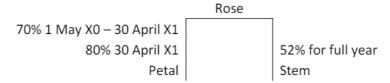
Consolidated Statement of Financial Position at 30 April 20X1

Assets	
Non-current assets	\$m
Property, plant and equipment (W11)	633
Goodwill (\$16m + \$6.2m) (W3)	22.2
Intangible assets (\$4m – \$1m) (W2)	3
Current assets (\$118m + \$100m + D330m/5)	284
Total assets	942.2

Equity and liabilities:	
Share capital	158
Retained earnings (W5)	267.37
Translation reserve (W7)	10.27
Other components of equity (W6)	4.73
Non-controlling interest (W4)	89.83
Total equity	530.2
Non-current liabilities (\$56m + \$42m + D160m/5)	130
Current liabilities (\$185m + \$77m + D100m/5)	282
Total equity and liabilities	942.2

Workings

(W1) Group structure



(W2) Net assets



Tutorial note

The identifiable net assets of a subsidiary at acquisition are recognised at fair value.

Petal

	Acq'n date	Rep date
	\$m	\$m
Share capital	38	38
Other equity	3	4
Retained earnings	49	56
FV adjustment – land (bal. fig)	30	30
FV of recognised net assets	120	128
FV adjustment – patent	4	4
Amortisation (\$4m/4 years)	_	(1)
FV of identifiable net assets	124	131

Of the net asset increase of \$7 million (\$131m - \$124m), \$1 million (\$4m - \$3m) relates to other components of equity and the remaining \$6 million relates to retained earnings.

Stem

	Acq'n date	Rep date
	Dinars m	Dinars m
Share capital	200	200
Other equity	-	_
Retained earnings	220	300
FV adjustment – land (bal. fig)	75	75
	495	575

The net asset increase of D80 million (D575m – D495m) all relates to retained earnings because Stem has no other components of equity.

(W3) Goodwill



Tutorial note

Goodwill is calculated on the date control is achieved. It is not recalculated when further share purchases are made.

Goodwill in an overseas subsidiary should be translated each year at the closing exchange rate.

Petal

	\$m
Fair value of consideration	94
Fair value of NCI at acquisition	46
Fair value of identifiable net assets acquired (W2)	(124)
Goodwill	16
Stem	
	Dinars m
Fair value of consideration (\$46m × 6 (acquisition rate))	276
Fair value of NCI at acquisition	250
Fair value of identifiable net assets acquired (W2)	(495)
Goodwill	31

Goodwill is deemed to be an asset of the subsidiary and is translated at the closing rate at each reporting date. Goodwill in Stem is therefore 6.2m (D31m/5).

(W4) Non-controlling Interest

(W4)	Non-controlling Interest	
		\$m
	Petal at acquisition (W3)	46
	NCI % of post-acquisition net assets $(30\% \times (\$131m - \$124m))$ (W2)	2.1
	Reduction in NCI due to share purchase (W10)	(16.03)
	Stem at acquisition (D250m/6) (W3)	41.67
	NCI % of post-acquisition net assets (48% × D80m/5.8) (W2)	6.62
	Exchange gain – goodwill (W8)	0.49
	Exchange gain on net assets (W9)	8.98
		89.83
(W5)	Retained earnings	
		\$m
	Rose	256
	Rose's share of post-acquisition retained earnings:	
	Petal (70% × \$6m) (W2)	4.2
	Stem (52% × D80m/5.8) (W2)	7.17
		267.37
(W6)	Other components of equity	
		\$m
	Rose	7
	Petal – negative movement in equity (W10)	(2.97)
	Share of Petal's post-acquisition other components $(70\% \times \$1m)$ (W2)	0.7
		4.73
(W7)	Translation reserve	
		\$m
	Exchange gain on goodwill (W8)	0.54
	Exchange gain on net assets (W9)	9.73
		10.27

(W8) Exchange gain on Stem'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		
	Dinars m	rate	\$m
Goodwill at 1 May 20X0 (W3)	31	6.0	5.17
Impairment	_	5.8	_
Exchange gain (bal. fig)	_		1.03
Goodwill at 30 April 20X1	31	5.0	6.2

The exchange gain is allocated between the group and the NCI as follows:

Group: $$1.03m \times 52\% = $0.54m (W7)$

NCI: $$1.03m \times 48\% = $0.49m (W4)$

(W9) Exchange gain on Stem's opening net assets and profit



Tutorial note

Exchange gains or losses arising on the opening net assets and profit of an overseas subsidiary must be apportioned between the group and the NCI.

		Exchange	
	Dinars m	rate	\$m
Net assets at 1 May 20X0 (W2)	495	6.0	82.5
Profit for the year (W2)	80	5.8	13.79
Exchange gain (bal. fig)	-		18.71
Net assets at 30 April 20X1 (W2)	575	5.0	115.0

The exchange gain on the opening net assets and profit is allocated between the group and the NCI as follows:

Group: $$18.71m \times 52\% = $9.73m (W7)$

NCI: $$18.71m \times 48\% = $8.98m (W4)$

(W10) Increase in ownership



Tutorial note

Goodwill is not recalculated when the group increases its shareholding in a subsidiary. Instead, the difference between the consideration for the additional shares and the reduction in the NCI is accounted for in other components of equity.

	\$m
Fair value of consideration	19
Reduction in NCI in Petal	
(10/30 × (\$46m + \$2.1m) (W4))	(16.03)
Negative movement (debit) in equity	2.97
(W11) Property, plant and equipment	
	\$m
Rose	385
Petal	117
Stem (D430m/5)	86
Petal fair value adjustment (W2)	30
Stem fair value adjustment (D75m/5) (W2)	15
	633

(b) Foreign exchange



Tutorial note

To score highly, this question requires a detailed knowledge of IAS 21. However, solid marks can still be obtained for demonstrating a basic understanding of the standard.

Monetary items

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. This would include foreign bank accounts, receivables, payables and loans. Non-monetary items are other items which are in the statement of financial position, such as non-current assets, inventories and investments in equity.

Monetary items are retranslated using the closing exchange rate (the year-end rate). The exchange differences on retranslation of monetary assets must be recorded in profit or loss. IAS 21 *The Effects of Changes in Foreign Exchange Rates* is not specific under which heading the exchange gains and losses should be classified.

Non-monetary items

Non-monetary items which are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. If non-monetary items are measured at fair value in a foreign currency then this amount must be translated using exchange rates at the date when the fair value was measured. Exchange differences on such items are recorded consistently with the recognition of the movement in fair values. For example, exchange differences on an investment property, a fair value through profit and loss financial asset, or arising on impairment will be recorded in profit or loss. Exchange differences on the upwards revaluation of property, plant and equipment would be recorded in other comprehensive income.

Overseas subsidiaries

When translating a foreign subsidiary, the exchange differences on all the net assets, including goodwill, are recorded in other comprehensive income and are held in equity. The proportion belonging to the shareholders of the parent will usually be held in a separate translation reserve. The proportion belonging to the non-controlling interest is not shown separately but subsumed in the non-controlling interest figure in the consolidated financial statements.

If Rose were to sell all of its equity shares in Stem, the cumulative exchange differences belonging to the equity holders of Rose will be reclassified from equity to profit or loss. In addition, the cumulative exchange differences attributable to the non-controlling interest would be derecognised but would not be reclassified to profit or loss.

Marking scheme		
		Marks
(a)	Amortisation of patent	1
	Acquisition of further interest	5
	Stem – translation and calculation of goodwill	6
	Retained earnings and other equity	4
	Non-controlling interest	3
	Property, plant and equipment	2
	Other assets/liabilities	1
		22
(b)	Currency issues – 1 mark per point	8
Total		30

SECTION A QUESTIONS - REPORTING AND ETHICAL IMPLICATIONS

21



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



Key answer tips

This is a typical SBR exam question 2 with some financial reporting knowledge and application (foreign currency principles in group accounts, intangible assets and revenue recognition) coupled with associated ethical issues.

Spend your time on each requirement in proportion to the marks allocated to it. Use most of your allotted time on (a) (ii) the ethics requirement (6 marks plus 2 professional marks) and least time on (a)(i) (3 marks).

Foreign exchange (a) (i)



Tutorial note

Identifying that the foreign currency gains are incorrectly treated (they should be taken to other comprehensive income rather than the P/L) is the key learning point here. Candidates should spot this issue fairly easily, and if not, must revise the foreign currency consolidation principles as this is a fundamental concept.

The content regarding the disposal of the subsidiary and the subsequent recycling out of OCI and into profit, whilst relevant, takes the discussion further than most candidates would.

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

(ii) Ethics



Tutorial note

Do not think about the financial reporting requirements and the ethics issues as mutually exclusive. Good answers will always strive to find the motivations for any incorrect accounting treatments (in this case, within in (a)(i)) and link them to potential ethical issues.

Be as specific as possible here. The requirement asks for the ethical issues caused by **Ms Malgun's** actions when managing Mr Raavi. Therefore, use the actual names, roles and details provided within the scenario to demonstrate how the actions of Ms Malgun cause ethical threats (e.g. Ms Malgun's expertise, the profit related payment received by Ms Malgun, Ms Malgun's delegation to an inexperienced Mr Raavi). Rote learned ethics answers do not score well, application to the scenario does.

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

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

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

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

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

(b) Sale of licence



Tutorial note

If this question considered the disposal of property, plant and equipment, most candidates would identify that Agency would record a gain or loss on disposal (not revenue). SBR will test similar situations for other, more complicated types of non-current asset (e.g. intangibles, financial assets). However, the result is no different to that of the disposal of PPE – a gain or loss on disposal recorded in profit calculated as proceeds less carrying amount.

The disposal of an intangible asset, as decribed in this scenario, will have the same outcome. Do not let the complications described in the scenario (e.g.variable consideration, development costs) prevent you from identifying this achievable conclusion.

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

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

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



Tutorial note

As per IFRS 15, variable consideration will only be recorded if it is highly probable that a signicant reversal will not occur. Here, the reversal of the variable consideration can only be refuted with confidence once the target of \$35m sales has been met.

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

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

(c) Drug development



Tutorial note

Remember the PIRATE criteria! Development costs can only be capitalised if the project is **profitable**, the company **intends** to use or sell the product, **resources** are available to complete the project, the company has the **ability** to use or sell the product, the project is **technically feasible** and the **expenditure** is identifiable.

Apply the rules to Agency's development costs and make a conclusion on the accounting treatment.

Development costs are capitalised as an intangible asset if certain criteria in IAS 38 are met.

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

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

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

ACCA marking guide		
		Marks
(a) (i)	Discussion and appropriateness of the accounting policy	3
(ii)	Application and discussion of ethical principles to scenario which includes: Employment contract Accounting policy and profit related pay Time pressures	6
	Competition	
	Less severe discipline	
		9
(b)	Discussion of key principles of IFRS 15 and relate to scenario Derecognition of intangible asset and IAS 38	2 2
	Calculation of gain	1
		5
(c)	Setting out principles for capitalisation	1
(0)	Application of principles to scenario	3
		4
	Professional marks	
	1101622101101111101172	
Total		20

Examiner's comments

Requirement (a) was conveniently split into two parts, so providing a helpful guide as to how long to spend on each aspect.

a) i) Three marks equates to just over five minutes, so your answer should be brief. On disposal of the foreign subsidiary, the related net exchange differences are reclassified from equity to the statement of profit or loss. So, had the subsidiary been disposed, the accounting treatment would have been appropriate.

However, this was not a disposal – the subsidiary was reclassified as held for sale. Your answer could have explained how the subsidiary should be accounted for under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and credit would be available for this. However, given the brevity of the requirement, and the focus on the exchange differences in the question, better (time-managed) answers explained that since no sale had yet been made, transfer of the accumulated foreign exchange gains from the other components of equity was not appropriate.

a)ii) This second requirement asks for a discussion of the ethical issues. Part (a)(ii) has a total of eight marks (6 marks plus the two professional marks for the quality of your discussion). A well planned answer that covers all the key areas and meets all the requirements is more likely to gain both professional marks. A discussion of ethical issues will include the identification of threats to impartiality, for example. You may want to begin by summarising the key issues from the scenario, and then link these with concerns you may identify.

Note that these issues don't just stem from what the finance director has done, but also the pressures placed on the student, and the systemic pressures placed on the finance director by the board. Remember that the requirement has six marks, so seven separate issues should have a very good chance of gaining a high score.

- b) For five marks, this question offers candidates a lot to describe: principles of derecognition under IAS 38 Intangible Assets, and principles of IFRS 15 Revenue from Contracts with Customers. Good answers would cover each aspect of the question in turn, leading to a short calculation of the gain on disposal of the development costs. Candidates who misread the requirement described the accounting requirements for Kokila Co with some answers describing lease accounting (wrongly assuming Agency Co retained control of the entire rights).
- c) The scenario describes a number of situations which should be familiar to candidates from their assumed knowledge of IAS 38 Intangible Assets. Candidates should be expected to apply their knowledge of the recognition requirements relating to development costs to the information provided in the scenario, and not merely list out the requirements. In this case what is key to the treatment as research or development is whether regulatory approval of the drug is achieved: without this, technical feasibility is not assured. Better answers considered the effectiveness of the asset in generating future economic benefit where the product is aimed at a small group of people who will only pay a notional amount. This last point was overlooked by quite a few candidates.

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



Key answer tips

This question includes some tricky, modern day accounting issues. However, do not get too bogged down in the technical bits. State the rules, apply them to the scenario and move on. In the Qn 2 style questions, you must get answers to the ethics part. There are 5 marks each for the accounting issues but 8 marks plus 2 professional marks for the ethics section. You must get answers to the ethics requirement to enable the marker to award the professional marks.

(a) Impairment testing of mines



Tutorial note

The important issue here is that an assessment as to whether the mines are impaired occurs under IAS 36. You must compare the carrying amount to the recoverable amount of the mines.

If you make a mistake (e.g. with the treatment of the decommissioning costs) it is still possible to conclude that the mine is impaired. A description of the accounting treatment of the impairment using your calculated figures will score subsequent OFR (own figure rule) marks.

N.B. If you erroneously left the decommissioning costs out of both the carrying amount and the recoverable amount, you will arrive at exactly the same impairment charge as provided in the answer!

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

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

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

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

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

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

(b) Class A and Class B shares



Tutorial note

Part (b) is particularly tricky and can take a while to decipher what is going on. Remember, it is only worth 5 marks. A maximum of 9 minutes to think about and write your answer. Therefore, keep your answer as simple as possible.

Answer the question – are Share A and Share B debt or equity? Use the definitions as per financial liabilities or equity instruments to help structure your opinion (e.g. to be a liability an obligation must exist so look for indications within the terms that suggest an obligation is or is not present). Present an argument for A, present an argument for B and quickly move on to the next requirement.

Do not think you must have an answer that uses exactly the same arguments as provided here within the published answer. The marker knows this is technically difficult and will reward candidates who show perseverance and the courage to provide an argument either way.

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

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

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

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

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

(c) Blockchain technology



Tutorial note

As always the ethics part has 2 professional marks associated with it, which makes it even more important to get an answer to the scenario. If you do not attempt the question, you cannot be awarded the professional marks.

The scenario here is very contemporary, focussing on issues arising from the implementation of Blockchain technology. Do not let this distract you from the main task of discussing the ethical issues. Candiates do not need a detailed understanding of how the technologies work, but should appreciate how it may affect the accountants involved. There are some very achieveable ethical conundrums to consider here regarding confidentiality, conflicts of interest and due competence and care.

The digital age and the problems it presents for accountants does seem to be a regular occurance within recent examinations (see the next question too).

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

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

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

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



Tutorial note

The list of points raised here are not necessarily exhaustive. If you raise other ethical issues which are reasonably justified by reference to specifics within the scenario, then the may gain credit as well.

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

Examiners comments

(a) This part of the question was generally answered quite well, although many candidates did not deduct the decommissioning provision from both the carrying amount and the recoverable amount of the mines. Most candidates did identify that there was an impairment loss often based upon inaccurate calculations. The own figure rule was used to assess the acceptability of candidates' conclusions.

However, there was little discussion of the acceptability of the use of the cash flow projections in the impairment assessment.

- (b) Many candidates discussed the issues but came to the wrong conclusion. This would simply mean that no marks would be given for the incorrect conclusion but with marks for sensible discussion still being available. This was an area were several candidates struggled. Most candidates produced a definition of the financial liability and identified that cryptocurrency could be treated as a 'cash' settlement. However, fewer candidates recognised that the class A shares should be classified as a liability with the class B shares being classified as equity. Marks were awarded for the application of the definitions of equity and liability to the scenario on the basis of one mark per valid and well discussed point up to a maximum of 5 marks.
- (c) Generally, one mark is allocated for each well discussed point raised by candidates. If candidates just listed ethical principles without application to the scenario, then a maximum of two marks would have been given. Marks are allocated as a result of using the scenario to demonstrate an understanding of the ethical issue. The actions required by the chief accountant in the published answer were more subtle in this question and looked at the act of whistleblowing and the issue surrounding such a process. However, if candidates discussed actions such as seeking advice from a colleague or ACCA, then these were appropriate answers and were awarded credit. Many candidates seem to think that accountants should resign immediately if they meet an ethical dilemma. The professional marks were awarded for a realistic discussion of the ethical issues set out in the scenario together with sensible and appropriate actions. Most candidates identified the key ethical issues in this scenario and achieved good marks, but fewer were able to suggest reasonable actions to resolve the situation.

Also, some candidates simply cut and pasted large sections of the exhibit and then stated 'this is an ethical issue'. This action would attract no marks. Candidates have to be sensible when using the cut and paste tool. Any examination would not reward a candidate for simply repeating the question back to the examiner. If candidates wish to use the cut and paste tool, then its use should be restricted to parts of a sentence that are relevant and they should add their own comments, and in this question, appropriate actions. It is very easy for a marker to recognise answers that have been cut and pasted.

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



Key answer tips

It would be easy to get bogged down in the tricky accounting issues in part (a) and the journals in part (b), but these two requirements are only worth 8 marks. Part (c) is worth 10 marks plus 2 professional marks - it is much easier to score well here, so leave yourself plenty of time to attempt it thoroughly.

(a) Revenue recognition

Control of the apartment block passes to the customer on completion. This is the point at which revenue should be recognised. Calibra is therefore incorrect to recognise revenue on receipt of payment.

There is a two year delay between payment and the transfer of the underlying asset. This means that, in accordance with IFRS 15 *Revenue from Contracts with Customers*, these advanced payments contain a significant financing component. In such cases, the revenue recognised should be the amount that the customer would have paid if they had paid cash at the date the good was transferred – i.e. \$9.55 million.



Tutorial note

Discuss the accounting treatment over the two year period – not just the initial entries on receipt of the cash.

On receipt of the payment, Calibra Co should recognise a liability of \$8.5 million. It should subsequently accrue interest on this liability at 6% each year, which will increase the carrying amount of the liability. After two years, the liability will have a carrying amount of \$9.55 million. When control of the apartment building is transferred, the liability is derecognised, and revenue of \$9.55 million recognised in the statement of profit or loss.

Borrowing costs



Tutorial note

This topic would have surprised many students because it is rarely examined. SBR has a big syllabus, but it is vital that you study it all.

IAS 23 *Borrowing Costs* states that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. A qualifying asset is one that takes a long time to get ready for use.

Apartment buildings take two years to construct so are qualifying assets. Calibra Co's business model is construction and, therefore, the applicable borrowing costs should be included in the cost of its inventory. Any other borrowing costs are recognised as an expense.

(b) Journal entries



Tutorial note

Many students struggle with journal entries, even though this is assumed knowledge for SBR. Make sure that the debits and credits balance.

Below are the journals produced by the examining team. The scenario says that cash received is posted to revenue, so your first journal might instead be:

Dr Revenue \$8.5m

Cr Liability \$8.5m

Removes the incorrect entry to revenue and records a liability.

Liability

Dr (\$m) Cr (\$m)

8.5

Cash 8.5

Records liability on receipt of cash (1/1/X8)

Inventory 0.51

Liability 0.51

Interest accruing on liability to 31/12/X8 (6% × 8.5m) included in the costs of inventory

Inventory 0.54

Liability 0.54

Interest accruing on liability to 31/12/X9 (6% × (\$8.5m + \$0.51m)) included in the costs of inventory

Liability 9.55

Revenue 9.55

Revenue arising on sale of apartment block.

The balance on the contract liability at 31/12/X9 would be \$9.55 million (\$8.5m + \$0.51m + \$0.54m). When control passes to the customer, Calibra Co derecognises the liability and recognises revenue of \$9.55 million.

(c) Ethics



Tutorial note

This is an unusual scenario and you may not have heard about distributed ledgers before. However, this does not mean that you can't answer the question. All that is required is knowledge of the ACCA ethical code and the ability to apply this.

ACCA's model solution makes continuous reference to the scenario. Try and do the same – it stops your answer becoming too generic and makes it more likely that you will be awarded the two professional marks.

Make explicit reference to the principles in the ACCA ethical code that are under threat – such as confidentiality and objectivity.

The chief accountant should not claim to have an understanding of distributed ledgers if he only has a basic knowledge. He should have seen evidence of whether the technology can be scaled up to the requirements of the directors before promising that he can facilitate the move. Also, he must convince himself that the reliability of the due diligence on the sale of property shares and that local regulations are complied with. In order to maintain integrity, professional accountants must be honest about whether they are comfortable with their knowledge of managing projects such as this. The chief accountant should not manage the project if he has doubts as to his knowledge as there may be significant issues as the project progresses. There may be a need to engage specialist consultancy input from distributed ledger experts. Similarly, the chief accountant should behave in a professional manner and determine whether the data on the distributed ledger breaks any confidentiality principles. He will need to consider the fact that local regulations may be violated and the repercussions thereof. The technology allows resale of the shares in the property and given the chief accountants worries over due diligence, illegal transfers of title ownership could be costly and time consuming to resolve. The chief accountant must also exercise independence of mind and not bow to political pressure from the board even though it may be a high-profile project for the company. He should inform the board of his reservations based upon his opinion and technical knowledge.



Tutorial note

The model answer written by ACCA is comprised of two large paragraphs. We would recommend keeping your points separate with plenty of white space between each one. This helps you keep track of how much you have written. It also makes the marker's job easier!

One of the main concerns for accounting professionals is the fear of losing objectivity in their judgment due to pressures from clients, employers, or other stakeholders. This occurrence would create a loss of professional identity for the person concerned. Some individuals are more vulnerable to loss of objectivity than others. Young accountants at the beginning of their career could be considered a vulnerable group, as they may be more easily influenced due to a perceived lack of experience and pressures from senior colleagues. The accountant has only just qualified and so might be inexperienced to be in the position of chief accountant. In this case, he has created a self-interest threat as the chief accountant has a personal interest in allowing Bodoni Co to pay the reduced amount 1 month after the contract for the purchase of the apartment block has been signed, as he wishes a good reference from the client when he applies for the permanent position. The pressure of applying for this position has inappropriately influenced his professional judgement and behaviour. Additionally, there is a threat to the chief accountant's objectivity which stems from a self-interest threat from the fear of losing Bodoni Co as a client which in turn would affect the accountant's chances of securing his position on a permanent basis.

ACCA marking guide		
		Marks
(a)	Application of the following discussion to the scenario:	
	 Revenue 	3
	 Borrowing costs 	2
		5
(b)	Journal entries	3
(c)	Discussion and application of ethical principles to scenario	10
	Professional marks	2
Total		20

Examiner's comments

In part (a), a significant number of candidates outlined the option of recognition 'over time', with some suggesting (incorrectly) that revenue can be recognised over the two-year period using some systematic method. Some candidates repeated the journal entries in both part (a) and part (b) which is wasting time. Make sure you read through all question requirements to avoid this.

Most answers to part (b) were clear and gained full marks, although some answers neglected to show the ultimate derecognition of the liability and recognition of revenue from the contract.

Answers to part (c) were in general good and many candidates provided a clear identification of the ethical issues and suggestions to resolve them. Conversely, a presentation of a "boiler plate" list of ethical responsibilities did not meet the requirements and gained very few marks, if any, unless applied to the two scenarios. Some candidates repeated too much information from the question without adding any new insights or concerns, which limited scope for marks. Overall, it is pleasing to see most answers identifying the threats and recommending appropriate actions to mitigate these and maintain ethical standards.

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



Key answer tips

The accounting issues tested this question are not technically demanding: provisions and related party transactions. Part (b) on ethics concentrates on a different issue than most recent SBR exams: confidentiality. Make sure that you are confident applying the ACCA Code of Ethics and Conduct to any situation that an accountant may face.

(a) (i) Restructuring



Tutorial note

State the criteria that must be satisfied for a provision to be recognised.

A provision for restructuring costs should only be recognised in the financial statements of Bagshot Co where all of the following criteria are met:

- A reliable estimate can be made of the amount of the obligation
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation
- There is a present obligation as a result of a past event.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that it would be extremely rare that no reliable estimate can be made.



Tutorial note

The principles governing the measurement of provisions are also relevant here.

A best estimate of the expenditure required to settle the present obligation should be provided as at 31 December 20X5 should all criteria be met. In the case of a restructuring provision, this should only include direct expenditure arising from the restructuring and not associated with ongoing activities. Hence the relocation costs would not be included as, although they relate directly to the restructuring, the costs would be classified as an ongoing activity.



Tutorial note

Apply the principles from the accounting standard to the scenario. Is there an obligation from a past event? Is payment probable?

It is not clear yet that restructuring payments are probable. Mrs Dawes has indicated that alternative strategies are possible and further clarification is required. Only then may it be determined that such restructuring payments are probable.



Obligations can be legal or constructive. A constructive obligation arises when an entity's past behaviour creates expectations about its behaviour in the future.

A constructive obligation for restructuring only arises where a detailed formal plan exists and a valid expectation to those affected by the restructuring that it will take place has occurred. A plan is in place but management does not yet appear committed as alternative strategies are possible. It is unlikely therefore that the plan is detailed and specific enough for these criteria to be satisfied. For example, the specific expenditure to be incurred, the date of its implementation and timeframe which should not be unreasonably long must be identified. With alternative strategies available, this does not appear to be the case. Furthermore, Mr Shaw is the only member of staff who has been notified and no public announcement has been made as at the reporting date. Consequently, there is no obligation in existence as at 31 December 20X5 and no provision can be recognised.

Mrs Dawes has identified that a final decision on the restructuring and communication is likely to take place before the financial statements are authorised. This would almost certainly be a material event arising after the reporting date but should be treated as non-adjusting. Accordingly, Bagshot Co should disclose the nature of the restructuring and an estimate of its financial effect but recognition of a restructuring provision is still prohibited.

(ii) Stewardship



Tutorial note

Stewardship is an important principle. According to the Conceptual Framework, one of the main purposes of financial reporting is to enable user groups to assess management's stewardship of an entity's resources.

Stewardship is an ethical principle which embodies the responsible planning and management of resources. The directors of Bagshot Co perform a stewardship role in that they are appointed by the shareholders to manage Bagshot Co on their behalf. The directors therefore assume responsibilities to protect the entity's resources from unfavourable effects of economic factors such as price and technological changes and to ensure that Bagshot Co complies with all laws, regulations and contractual obligations. Group results have been disappointing in recent years although no specific causes have been identified. It could be argued, therefore, that the restructure is acting in good faith and reflecting good principles of stewardship. It is anticipated that long-term shareholder value will be enhanced from the proposals.



The effectiveness of stewardship can only be assessed if an entity's financial statements faithfully represent its performance, position and cash flows.

A second factor of good stewardship is that it is important that investors, both existing and potential, and lenders have reliable and accurate information about the entity's resources so that they can assess how efficiently and effectively the entity's management and governing board have discharged their responsibilities. It is important therefore that the financial statements are transparent, objective and comply fully with IFRS Standards. Mrs Dawes wants Bagshot Co to include a restructuring provision as at 31 December 20X5 even though no obligation arises. Whilst prudence is a guiding principle when dealing with issues of uncertainty, excessive prudence cannot be justified. As a qualified member of ACCA, it should be apparent to Mrs Dawes that no provision should be recognised and to include one would be misleading to the stakeholders of Bagshot Co.

(iii) Related parties

Mrs Shaw's acquisition of the equity shares in Bagshot Co would be deemed a related party transaction if the acquisition enabled her to control or have significant influence over Bagshot Co.



Tutorial note

Control is assumed when an investor owns more than 50% of the voting rights of the investee. Significant influence is assumed if the holding is between 20% and 50%.

A person is a related party of an entity that they control or have significant influence over. Mrs Shaw has a 5% interest, which is way below the threshold to exercise control. Mrs Shaw has a holding of less than 20% of the voting power so it is very unlikely that she has significant influence over the entity.

Bagshot Co's directors would be related parties of Bagshot Co. However Mrs Shaw is unaware of the proposed restructure which suggests that she does not have a board position.

Mrs Shaw would be deemed to be a close family member of Mr Shaw and so would be a related party of Bagshot Co if it was concluded that Mr Shaw is a member of key management personnel of Bagshot Co.



Tutorial note

Close family includes children, spouses or domestic partners.

Mr Shaw is the head accountant of Bagshot Co but it seems highly unlikely that he would be deemed to be key management personnel. There is no evidence that he has authority or responsibility for planning, directing and controlling the activities of Bagshot Co. Nor does he appear to be a director of the entity.



Tutorial note

Make sure that you reach an explicit conclusion.

Based on the above, it can be concluded that Mrs Shaw's acquisition of the 5% of the equity in Bagshot Co is not a related party transaction.

(b) Ethics



Tutorial note

Explain which principles in the Code of Ethics have been breached — such as objectivity, integrity and confidentiality.

Mr Shaw is facing a number of ethical dilemmas arising from the scenario. Mrs Dawes's insistence that a restructuring provision should be included could constitute an intimidation threat to objectivity, although her motivation for including the provision early is unclear. Mr Shaw is also a qualified member of ACCA and therefore should be aware that the treatment is inconsistent with international accounting standards. Mr Shaw must adhere to the ACCA Code of Ethics and prepare financial statements diligently which are objective and fully comply with IFRS Standards. He must not comply with Mrs Dawes's requests and should politely remind her of her professional responsibilities as a member of ACCA. Non-compliance with accounting standards would be a breach of a range of ethical principles including professional competence, professional behaviour and objectivity. Assuming that Mrs Dawes is aware of the error, her integrity would also be questionable.



Tutorial note

Insider trading is an important issue in real life, although it has not been regularly examined in SBR.

Mr Shaw could be accused of insider trading were he to inform his wife of the proposed restructure. Insider trading involves the use of non-publicised information in order to make decisions on financial investments based on the information which others do not yet know about. It is clear that such behaviour would not be ethical since Mrs Shaw would be in an advantageous position to make investment decisions which could impact unfairly on the other shareholders. Insider traders have information which others do not have such that the other stakeholders may act differently and make different decisions should they have been privy to the same information. Such activities are seen as fraudulent and are likely to be in breach of local money laundering regulations.

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Clearly recommend actions to be taken. They can be very simple - e.g. do not disclose the confidential information.

Mr Shaw has become privy to confidential information regarding Bagshot Co. One of ACCA's key ethical principles is that of confidentiality. Information must not be disclosed to others unless there is a legal or professional right or duty to disclose. Professional accountants must also ensure that they do not use confidential information for their own personal benefit. Mr Shaw has self-interest threats arising both from his wife's ownership of the shares and from his nephew facing potential redundancy. His wife could use the information to consider whether she may wish to sell her 5% ownership interest. Mr Shaw may also feel pressure to inform his nephew of the potential redundancy he may be facing. This may allow his nephew to obtain an unfair advantage over fellow employees by, for example, examining other opportunities in the labour market. Mr Shaw must not disclose the confidential information to his wife or his nephew.

ACCA Marking scheme			
			Marks
(a)	(i)	Discussion of IAS 37 criteria and restructuring	3
		Application of above to scenario	2
		Identification of non-adjusting event	1
			6
	(ii)	What is meant by good stewardship	2
	()	Examples of good stewardship	2 2
		Examples of Book Stewardship	
			4
	(iii)	Control/significant influence criteria	2
	(,	Recognition of close family member	1
		necognition of close family member	
			3
			,
/h)		Intimidation threat	1
(b)			1 2
		Insider trading	
		Confidentiality	2
			5
		Professional marks	2
Total			30

Examiner's comments

Despite there being 6 marks available for answering part (a) (i), many answers were the same length as for (a) (iii) despite the latter having only 3 marks. Answers to part (a) (ii) were rather weak; many candidates overlooked the 'knowledge' aspect of explaining what constitutes a related party; most answers did not consider the relevance of the proportion of shares held. Such answers jumped straight to considering the position held by Mr Shaw and assumed that he was in a position of key management (despite not being a director). Many answers gave the wrong conclusion as a result. Answers to part (b) were generally good, with a clear identification of the ethical issues and suggestions to resolve them (which in this case includes simply maintaining confidentiality).

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



Key answer tips

Your discussion of the three accounting issues can only score you 11 marks. Make sure that you manage your time carefully. Your answers should be much briefer than the model answer below. Don't forget to comment on the gearing impact - this will earn you three quick marks.

Easy marks can be obtained in ethics questions for discussing the actions that the accountants in the scenario should take.

(a) Cash advance



Tutorial note

Directors are members of key management personnel and therefore are related parties of the reporting entity.

IAS 24 Related Party Disclosures requires an entity's financial statements to contain disclosures necessary to draw attention to the possibility that its financial statements may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

The finance director of Stent Co is a related party of Stent Co. The finance director controls Budster Co and therefore Stent Co and Budster Co are related parties of one another. As such, Stent Co must disclose the nature of the related party relationship with Budster Co as well as information about all transactions and outstanding balances between Stent Co and Budster Co.

According to the Conceptual Framework, the advance from Budster Co is a liability: Stent Co has a present obligation (legally enforceable as a consequence of a binding contract), the settlement of which involves Stent Co giving up resources embodying economic benefits in order to satisfy the claim.



Bar some exceptions, IFRS Standards do not permit offsetting.

Except when it reflects the substance of the transaction or other event, offsetting detracts from the ability of users to understand the entity's transactions and to assess the entity's future cash flows. IAS 1 *Presentation of Financial Statements* states that an entity shall not offset assets and liabilities, unless required or permitted by an IFRS Standard. Offsetting a financial asset and a financial liability is permitted according to IAS 32 *Financial Instruments: Presentation* when, and only when, an entity has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. No such agreement is evident in this case, so Stent Co should report the receivables and the advance separately.

If the error was not corrected, Stent Co would be showing a lower current asset figure and concealing the liability. If disclosed as a current liability it might be included in the debt element of the gearing calculation, thus increasing gearing.

Convertible redeemable preference shares



Tutorial note

Memorise the definitions of financial assets, financial liabilities and equity. The classification of financial instruments is a popular exam topic.

IAS 32 defines an equity instrument as any contract which evidences a residual interest in the assets of an entity after deducting all of its liabilities. An equity instrument has no contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities under potentially unfavourable conditions. If settled by the issuer's own equity instruments, an equity instrument has no contractual obligation to deliver a variable number of shares.

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer either to deliver cash or another financial asset to the holder, or to exchange financial assets or financial liabilities with the holder, under conditions which are potentially unfavourable to the issuer.

The preference shares offer the holder the choice of conversion into ordinary shares as well as redemption in two years' time. Stent should separately recognise a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity).



Don't just tell the examiner that the instrument should be split into liability and equity components. Explain how these components are measured.

Stent Co would measure the fair value of the consideration in respect of the liability component based on the fair value of a similar liability without any associated equity conversion option. The equity component is assigned the residual amount.



Tutorial note

Remember to comment on gearing. The gearing ratio will deteriorate if liabilities increase.

Correction of the error would increase non-current debt (the present value of the future obligations) and decrease equity. This will increase gearing.

Deferred tax asset



Tutorial note

Recognition of a deferred tax asset in respect of unused tax losses is a common exam topic. Make sure that you memorise the key principle below.

In accordance with IAS 12 *Income Taxes*, a deferred tax asset shall be recognised for the carry-forward of unused tax losses to the extent that it is probable that future taxable profit will be available against which the unused tax losses can be utilised.

However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses only to the extent that it has convincing evidence that sufficient taxable profit will be available against which the unused tax losses can be utilised. In such circumstances, the amount of the deferred tax asset and the nature of the evidence supporting its recognition must be disclosed.

The directors of Stent Co should consider whether it is probable that Stent Co will have taxable profits before the unused tax losses or unused tax credits expire, whether the unused tax losses result from identifiable causes which are unlikely to recur; and whether tax planning opportunities are available to the entity which will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised. To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset should not be recognised.



Don't forget gearing. The carrying amount of equity equals the carrying amount of net assets – so a reduction in assets causes a corresponding reduction in equity, meaning that the gearing ratio will deteriorate.

The removal of a deferred tax asset would reduce net assets and, therefore, equity. Gearing would increase.

(b) Ethical aspects



Tutorial note

Do not attempt the ethics requirement first. If you work through and understand the accounting errors made then you will have more specific comments to make about ethics in part (b). This will improve the quality of your answer and also make it more likely that you will receive the professional marks available.

The ACCA Rulebook contains the bye-laws, regulations and *Code of Ethics and Conduct*, which every ACCA member should follow. The accountant may feel pressured by the finance director's comments on job security given the accountant has only been in her position for a few months. The accountant should comply with the fundamental ethical principles set out in the ACCA Rulebook: to act with integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. The accountant should be mindful of any threats to these fundamental ethical principles. In doing so, the accountant should consider the relevant facts, the ethical issues involved, the fundamental principles which are threatened, whether internal procedures exist which mitigate the threats, and what alternative courses of action could be taken.



Tutorial note

Comment on the ethical principles that are threatened in the scenario and explain why this is the case.

In this case, all fundamental ethical principles with the exception of confidentiality appear under threat. The finance director appears to be allowing bias and undue influence from the pressures imposed by debt covenant gearing and overdraft limits into the choice of accounting treatment, rather than following accounting standards. The company is in a precarious position, reporting losses in the year. The finance director should act professionally, in accordance with applicable technical and professional standards, comply with relevant laws and regulations, and avoid any action which discredits the profession.

The accountant faces an intimidation threat to objectivity given the comments from the finance director, who presumably has an influence over career prospects. Assuming the accountant wishes to keep her job, this intimidation threat also gives rise to a self-interest threat to objectivity.



Tutorial note

What should the accountant do now?

Before acting, the accountant should speak with the finance director, try to confirm the facts, and discuss the treatment with the finance director and explain the risks of non-compliance. A record of conversations and actions should be kept. Stent Co may also have internal procedures which mitigate the threats. It may be that the finance director is not technically up-to-date, in which case a safeguard would be to undergo continuing professional development. If the finance director refuses to comply with accounting standards, then it would be appropriate to discuss the matter with other directors or an audit committee (if applicable), to seek a solution, then seek professional advice from ACCA, and consider legal advice if necessary. A final consideration for the accountant, if matters cannot be satisfactorily resolved, would be resignation.



Tutorial note

Resignation is often a last resort!

ACCA marking guide		
		Marks
(a)	 application of the following discussion to the scenario: 	
	cash advance from related party	4
	preference shares: convertible	4
	deferred tax asset	3
		11
(b)	– discussion of ethical principles	2
	– application of ethical principles to the scenario, and recommended action	5
		7
	Professional marks	2
Total		20

Examiner's comments

A surprising number of candidates failed to comment on the impact of gearing; otherwise however, answers to part (a) were good. Most candidates identified the accounting errors in the described scenario; although in some cases failed to identify the need for a related party disclosure. Candidates' explanation for the accounting treatment of convertible preference shares often lacked application to the scenario.

Marks were divided between identification of ethical issues and actions that the accountant should take to resolve the issues. Answers were generally good, with a clear identification of the ethical issues and suggestions to resolve them. However candidates that combined both parts (a) and (b) tended to repeat themselves; and some answers to part (b) were segmented on the basis of the accounting issues, which again lead to repetition, since the ethical issues in most cases related to all of the three accounting issues. Despite these issues, the question was very well-answered in general.

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



Key answer tips

Question 2 in the SBR exam requires students to discuss the accounting and ethical implications of particular transactions. Pay careful attention to the mark allocation because these are lower in question 2 than in other parts of the paper. For instance, part (b) is only worth 5 marks and so you only need to write five separate points. It would be easy to write too much here and therefore waste time.

Remember that your answer to part (c) must be specific to the scenario. Comment on the particular errors made by Hudson, the specific ethical principles breached, and the actions that should be taken. If you do this then you will be awarded 2 professional marks.

Settlement costs (a)



Tutorial note

On first read through this question seems quite tricky. However, there are easy marks if you adopt a logical approach. Begin your answer by describing the nature of a remeasurement component.

According to IAS 19 Employee Benefits, the remeasurement component is presented in other comprehensive income. It comprises:

- Actuarial gains and losses
- Returns on plan assets not included in the net interest component
- Changes in the asset ceiling not included within the net interest calculation.

Actuarial gains and losses result from differences between actuarial assumptions and what actually occurred during the period. These will arise in instances such as unexpected movements on interest rates, unexpectedly high or low rates of employee turnover or unexpected increases or decreases in wage growth.

The effects of the redundancy exercise are not part of the remeasurement component.

A redundancy exercise is an example of a curtailment because it significantly reduces the number of employees covered by the plan. Per IAS 19, the present value of the change in the defined benefit obligation as a result of a curtailment is a past service cost and should be recognised in profit or loss.



Tutorial note

Make sure that you discuss both the basic enhancement and the additional enhancement.

The basic enhancement is an obligation that Hudson must pay as compensation for terminating the employee's services regardless of when the employee leaves the entity. IAS 19 *Employee Benefits* requires such payments to be recognised at the earlier of when the plan of termination is announced and when the entity recognises the associated restructuring costs associated with the closure of Wye. Hudson should therefore have provided in full for the cost of the basic settlement regardless of whether the staff have left or not. This should be recognised as part of the past service cost in the profit or loss of Hudson for the year ended 31 December 20X2.

The additional pension enhancement is only received by employees who complete service up to the closure of division Wye. In effect, the enhancement is in exchange for the period of service until redundancy. Hudson should estimate the number of employees who will remain with Hudson until the closure of Wye and spread the estimated total cost over the period of service. This should be included within the current service cost, thus having an adverse effect on the profit or loss in both 20X2 and 20X3.

Redundancy costs

As set out in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* an 'obligating event' must have arisen before a provision can be recognised. With regards to restructuring, a present obligation from a past event arises if:

- a detailed formal plan for the restructuring is in place, and
- a valid expectation has been created in those affected that the restructuring will be carried out, either by starting to implement the plan or publicly announcing its main features.



Apply the criteria in IAS 37 to Hudson.

In the case of Hudson, a valid expectation has been created because the restructuring has been announced, the redundancies have been confirmed and the directors have approved the restructuring in a formal directors' meeting. A restructuring provision should therefore be recognised.



Tutorial note

Many students will simply discuss **whether** a provision should be recognised, and omit any reference to how the provision should be measured.

IAS 37 specifies that only the direct expenditure which is necessary as a result of restructuring can be included in the restructuring provision. This includes costs of making employees redundant and the costs of terminating certain contracts. However, the provision cannot include the costs of retraining or relocating staff, marketing or investment in new systems and distribution networks, because these costs relate to future operations.

(b) Deferred tax



Tutorial note

State the principles from IAS 12 with respect to the recognition of a deferred tax asset for unused tax losses. The question is only worth five marks – you would not be expected to reproduce the content below.

IAS 12 Income Taxes says that a deferred tax asset shall be recognised for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.



Use the information from the scenario to explain whether it is probable that Hudson will make taxable profits before its tax allowable losses expire.

Hudson operates under a tax jurisdiction which only allows losses to be carried forward for two years. The maximum total losses that can be utilised are therefore equal to total unused losses for 20X1 and 20X2. Losses incurred before 20X1 can no longer be carried forward and so no deferred tax asset should be recognised in respect of them.

The directors of Hudson should base their forecast of future profitability on reasonable and supportable assumptions. There appears to be evidence that this is not the case. Hudson has a recent history of trading losses and there is little evidence that there will be an improvement in trading results within the next couple of years. The market is depressed and sales orders for the first quarter of 20X3 are below levels in any of the previous five years. It is also likely that Hudson will incur various costs in relation to the restructuring which would increase losses into 20X3 and possibly 20X4. Only directly attributable expenses such as redundancies should be included within a provision and expensed in 20X2 which would increase the current year loss. On-going expenses may be incurred such as retraining and relocating costs but these should only be expensed from 20X3. The forecast profitability for 20X3 and subsequent growth rate therefore appear to be unrealistically optimistic.



Tutorial note

Reach an explicit conclusion about whether a deferred tax asset can be recognised.

Given that losses can only be carried forward for a maximum of two years, it is unlikely that any deferred tax asset should be recognised.

(c) Ethics



Tutorial note

Your answer must be specific to Hudson. Discuss particular issues in the scenario that increase the likelihood of financial statement manipulation (e.g. performance related bonuses).

Directors have an ethical responsibility to produce financial statements which are a faithful representation of the entity's transactions. The directors of Hudson are paid a bonus based upon earnings before interest, tax depreciation and amortisation (EBITDA) and so a self-interest threat to objectivity arises. The directors have an incentive to manipulate the financial statements in order to try to minimise the losses and maximise profits. Similarly the directors have an incentive to maximise assets and minimise liabilities so that Hudson complies with its debt covenants.