

Tutorial note

Discuss the particular errors made by Hudson – such as the treatment of the pension enhancements, the restructuring provision, and the deferred tax asset.

There is evidence that the directors are willing to manipulate the financial statements in a way directly contrary to the ethical principles of integrity and objectivity. The expenses arising from the basic and additional pension enhancements should be recorded in profit or loss but the directors wish to recognise this within other comprehensive income despite knowing that it is contrary to IFRS Standards. This would improve profitability.

The directors also have not recognised a restructuring provision despite the terms being communicated to staff. As a result, profit and net assets are overstated. This may make it more likely that the bonus target is met and that the debt covenants are not breached. It is possible that restructuring would be treated as an exceptional cost in profit or loss and may therefore not impact the bonus. It would therefore be useful to examine the precise terms of the contracts in order to assess the potential impact on the bonus.

The deferred tax asset is based upon forecasts for too long a period and is also based on unrealistic assumptions. Net assets will be overstated, helping Hudson to meet its debt covenant obligations.

The directors' explanation for their proposed treatments are not justified. Directors are appointed to run the business on behalf of the company's shareholders who are the primary stakeholder. It will be in the shareholders' interests for the company to be profitable and to maintain net assets within the debt covenant stipulations. However, this should not be at the expense of the credibility and transparency of the financial statements. Deliberate manipulation of financial statements will reduce stakeholders' confidence in the reliability of the financial statements and the accountancy profession as a whole.



Tutorial note

Discuss the specific ethical principles that the directors are contravening. Do not simply list all of the ethical principles in the ACCA Code of Ethics and Conduct.

The directors' actions with regard to the accountant are contrary to the ethical principles of professional behaviour. It appears that the directors have put the accountant under undue pressure to falsify the financial statements to meet their own needs. An intimidation threat to objectivity arises from the directors' implying that the accountant would lose their job should they not comply with the directors' instructions.



Tutorial note

State the actions needed to resolve the above.

The accountant would also be bound by the ACCA *Code of Ethics and Conduct* and must adhere to the same ethical principles. They must not therefore comply with the directors' instructions and should instead remind the directors of their obligations to comply with this code. Should the accountant feel unable to approach the directors directly, they could consider talking to those charged with governance and, in particular, non-executive directors to explain the situation. The accountant could also seek help from the ACCA ethical helpline and take legal advice. Ultimately, if the situation cannot be resolved, the accountant could consider resigning and seeking employment elsewhere.

	ACCA marking guide	
		Marks
(a)	 application of the following discussion to the scenario: what should be included in the remeasurement component correct treatment of the basic enhancement correct treatment of the additional pension enhancement discussion of restructuring costs 	2 2 2 2
	Maximum	8
(b)	- an explanation of IAS 12 principles	2
	 application of above discussion to the scenario 	
	Maximum	5
(c)	 application of the following discussion of accounting issues to the scenario: 	ļ
	termination payments	2
	tax losses	1
	 consideration of the ethical implications and their resolution 	2
	Maximum	5
	Professional marks	2
	Professional marks	
Total		20

Examiner's comments

Better answers apply ethical principles to the scenario. Indeed, it was pleasing to see fewer answers merely 'listing out' rote-learned ethical requirements in this sitting. Most candidates identified that there was a second requirement to outline the implications for the accountant and many answers included suggestions for how the accountant might resolve the ethical issue.

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



Key answer tips

Read the question properly. Part (a) has three requirements: discuss the accounting treatment of the building, explain the impact on the financial statements, and explain the impact on debt covenants. You will miss out on valuable marks if you only discuss the correct accounting treatment.

Part (b) tests revenue recognition. To answer this you need to know the criteria for when revenue is recognised over time.

Nearly half of the available marks in this question are allocated tor ethics (part (c)). Do not neglect this. Make sure that your answer details with the specific accounting issues in the question, and the specific ethical principles that have been breached.

(a) Accounting treatment

According to IFRS 16 Leases, the lease is a finance lease. This is because the lease term is equal to the useful life and its residual value is deemed to be minimal. As such, the property should not be held as an investment property but instead derecognised. The fair value gain of \$8 million must be reversed. Fiskerton should record a lease receivable equal to the net investment in the lease.



Tutorial note

If the lease was an operating lease then the property should have been presented as an investment property. Rental income would be recognised in profit or loss on a straight line basis.

Note that the fair value gains were incorrectly calculated since adjustments should have been made for the differences between the Halam building and the one sold due to the different location and quality of the materials between the two buildings.



Tutorial note

IFRS 13 Fair Value Measurement states that fair value is the price received when an asset is sold in an orderly transaction between market participants at the measurement date. When deciding on a sale/purchase price, participants would factor in the condition and location of an asset and any restrictions on its use.

A more accurate reflection of fair value would have been \$22 million.

Impact on financial statements



Tutorial note

Easy marks are available for recalculating the gearing ratio.

The incorrect treatment has enabled Fiskerton to remain within its debt covenant limits. Gearing per the financial extracts is currently around 49.8% (50/(10 + 20.151 + 70.253)). Fair value gains on investment properties are reported within profit or loss. Retained earnings would consequently be restated to \$62.253 million (\$70.253m - \$8m). Gearing would subsequently become 54.1% (50/10 + 20.151 + 62.253). Furthermore, retained earnings would be further reduced by correcting for rental receipts. These presumably have been included in profit or loss rather than deducted from the net investment in the lease. This would in part be offset by interest income which should be recorded in profit or loss at the effective rate of interest.

After correcting for these errors, Fiskerton would be in breach of its debt covenants. They have a negative cash balance and would appear unlikely to be able to repay the loan. Serious consideration should therefore be given as to whether Fiskerton is a going concern. If it is determined that Fiskerton is not a going concern then non-current assets and non-current liabilities should be reclassified to current and recorded at their realisable values.



Tutorial note

According to IAS 1 Presentation of Financial Statements, going concern uncertainties must be disclosed in the financial statements.

If Fiskerton can renegotiate with the bank then the uncertainties surrounding their ability to continue to trade must be disclosed.

(b) Revenue



Tutorial note

Do not simply recite the five steps of the revenue recognition model. A lot of this is irrelevant to answering the question. The requirement asks you about the timing of revenue recognition – so only the fifth step is relevant.

Make sure that you know the criteria for recognising revenue over time.

According to IFRS 15 *Revenue from Contracts with Customers*, at the inception of the contract, Fiskerton must determine whether its promise to construct the asset is a performance obligation satisfied over time.

During the production of the asset Fiskerton only has rights to the initial deposit and has no enforceable rights to the remaining balance as construction takes place. Therefore Fiskerton would not be able to receive payment for work performed to date. As such, revenue should not be recognised over time but at the point in time when control passes to the customer (most likely on delivery of the asset to the customer).

(c) Ethics

It is concerning that the property has been incorrectly classified as an investment property. Accountants have an ethical duty to be professionally competent and act with due care and attention. It is fundamental that the financial statements comply with the accounting standards and principles which underpin them. This may be a genuine mistake but even so would not be one expected from a professionally qualified accountant. The financial statements must comply with the fair presentation principles embedded within IAS 1 Presentation of Financial Statements.



Tutorial note

Outline the **specific** ethical principles that have been breached.

The managing director appears to be happy to manipulate the financial statements. A self-interest threat to objectivity arises from the issue over the debt covenants. It is likely that the managing director is concerned about his job security should the bank recall the debt and deem Fiskerton to no longer be a going concern. It appears highly likely that the revaluation was implemented in the interim financial statements to try to maintain a satisfactory gearing ratio. Even more concerning is that the managing director has deliberately overstated the valuation for the year-end financial statements, even though he is aware that it breaches accounting standards. Such deliberate manipulation is contrary to the ethical principles of integrity, professional behaviour and objectivity. It appears that the managing director is trying to defraud the bank by misrepresenting the liquidity of the business to avoid repayment of the loan.



Tutorial note

Make explicit reference to the impact of the revenue error on the financial statements.

The sales contract is further evidence that the managing director may be attempting to manipulate the financial statements. The proposed treatment will overstate both revenue and assets which would improve the gearing ratio.

A governance issue arises from the behaviour of the managing director. It is important that no one individual is too powerful and domineering in running an entity's affairs. An intimidation threat arises from the managing director pressurising the accountant to overstate revenue from the contract. It was also the managing director who implemented the excessive revaluations on the property. It would appear that the managing director is exercising too much power over the financial statements.



Tutorial note

Outline specific actions that the accountant should take.

The accountant must not be influenced by the behaviour of the managing director and should produce financial statements which are transparent and free from bias. Instead, the managing director should be reminded of their ethical responsibilities. The accountant may need to consider professional advice should the managing director refuse to correct the financial statements.

	Marking guide	
		Marks
(a)	 application of the following discussion to the scenario: correct accounting treatment of the lease implications for the financial statements implications for the debt covenant 	3 2 2
(b)	 consideration of whether it is performance satisfied over time or at a point in time and application to the scenario conclusion and implications for revenue 	7 3 1 4
(c)	 application of the following discussion of ethical issues to the scenario: classification of property as investment property revaluation and manipulation of the debt covenant consideration of the ethical implications and their resolution 	2 3 2
Total	Professional	2 2

Examiner's comments

Many candidates felt that the investment property classification was justified. Where a candidate concluded, with some justification, that the property was an investment property, some marks were awarded. Where candidates made a reasonable attempt at calculations, then the Own Figure Rule was used to justify the conclusions reached by the candidate.

The second part of the question required a discussion as to whether revenue arising from a sales contract should be recognised on a stage of completion basis under IFRS 15. Any mention of IFRS 15 in a question seems to prompt a regurgitation of the five steps to revenue recognition. This type of answer gains very few marks as this level of exam requires candidate knowledge of the specific requirement in IFRS 15. Thus in this case, candidates should have stated that the entity should determine whether its promise to construct the asset is a performance obligation satisfied over time. Generally, candidates obtained at least half marks on this part.

The final part of the question was generally well answered and full marks were often awarded. The main issue was that some candidates simply quoted ethical guidance without applying it to the scenario. Also, the professional marks were awarded for the quality of ethical discussion and thus where candidates did not apply ethical guidance to the scenario, further marks were lost.

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



Key answer tips

This question shows the marks available for each part. Use this to help you with timings. Almost half of the marks are for ethics, so make sure that you write enough. You will score one mark for each valid point that you make.

Ethical issues are never clear-cut. To score the two professional marks, your discussion must demonstrate an understanding of the reality of a problem.

(a) Factory subsidence



Tutorial note

Use subheadings so that it is clear which issue you are addressing.

In accordance with IAS 36 Impairment of Assets, the subsidence is an indication of impairment in relation to the production facility.

The impairment review would be performed on a suitable cash generating unit as presumably the factory, as a standalone asset, would not independently generate cash flows for Farham.



Tutorial note

A cash generating unit is the smallest group of assets that generate cash flows that are independent from the rest of the business.

The recoverable amount of the unit would need to be assessed as the higher of fair value less costs to sell and value in use.

Reference to IFRS 13 Fair Value Measurement would be required in estimating the fair value of the facility. This may involve considering whether similar facilities have been on the market or recently sold.

Value in use would be calculated by estimating the present value of the cash flows generated from the production facility discounted at a suitable rate of interest to reflect the risks to the business.

Where the carrying amount exceeds the recoverable amount, impairment has occurred. Any impairment loss is allocated to reduce the carrying amount of the assets of the unit. This cannot be netted off the revaluation surplus as the surplus does not specifically relate to the facility impaired. As such the impairment should be recorded in profit or loss.

No provision should be recognised for the costs of repairing the factory. To recognise a provision, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* would require a legal or constructive obligation to repair the factory. No such obligation exists

Sale of Newall

The disposal of Newall appears to meet the criteria to be held for sale as per IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. Management has shown commitment to the sale by approving the plan and reporting it to the media. A probable acquirer has been found, the sale is highly probable, and it is expected to be completed six months after the year end (well within the 12-month criteria).



Tutorial note

A disposal group is a group of assets that will be disposed of in a single transaction.

Newall would be treated as a disposal group because a single equity transaction is the most likely form of disposal.

If Newall is deemed to be a separate major component of business or geographical area of the group, the losses of the group should be presented separately as a discontinued operation within the consolidated financial statements of Farham.

Assets held for sale are valued at the lower of carrying amount and fair value less costs to sell. The carrying amount consists of the net assets and goodwill relating to Newall less the non-controlling interest's share.

Assets within the disposal group which are not inside the scope of IFRS 5 are adjusted for in accordance with the relevant standard first. This includes leased assets. The right-of-use asset deemed surplus to requirements will most likely be written off with a corresponding expense recognised in profit or loss.

Any further impairment loss recognised to reduce Newall to fair value less costs to sell would be allocated first to goodwill and then on a pro rata basis across the other non-current assets of the group.



Tutorial note

A constructive obligation is where an entity's past behaviour and practice indicates to other parties that it will accept certain responsibilities.

The chief operating officer is wrong to exclude any form of restructuring provision from the consolidated financial statements. The disposal has been communicated to the media and a constructive obligation exists. However, only directly attributable costs of the restructuring should be included and not ongoing costs of the business. The legal fees and redundancy costs should be provided for. Future operating losses should not be provided for because no obligating event has arisen. No provision is required for the impairments of the owned assets as this would have been accounted for on remeasurement to fair value less costs to sell.



Tutorial note

If the lease will be terminated then the lease term has changed.

If the early termination penalty is likely to be paid then the lease term has changed. Per IFRS 16 *Leases*, the lease liability must be remeasured and should now include the present value of the penalty (but should exclude any payments scheduled after this date). When the lease liability is remeasured, a corresponding adjustment is posted against the right-of-use asset. If the right-of-use asset has been written down to zero an expense should instead be charged to profit or loss.

(b) Ethics



Tutorial note

Financial statement errors are an ethical issue, even if they were accidental. Accountants have a responsibility to be professionally competent so that primary user groups are not misled.

Accountants have a duty to ensure that the financial statements are fair, transparent and comply with accounting standards. The accountant has made mistakes that would be unexpected from a professionally qualified accountant. In particular, the accountant appears unaware of which costs should be included within a restructuring provision and has failed to recognise that there is no obligating event in relation to future operating losses. Accountants must carry out their work with due care and attention for the financial statements to have credibility. They must therefore ensure that their knowledge is kept up to date and that they do carry out their work in accordance with the relevant ethical and professional standards. Failure to do so would be a breach of professional competence. The accountant must make sure that they address this issue through, for example, attending regular training and professional development courses.



Tutorial note

Discuss the specific impact of the errors on the financial statements.

There are a number of instances which suggest that the chief operating officer is happy to manipulate the financial statements for their own benefit. She is not willing to account for an impairment loss for the subsidence despite knowing that this is contrary to IFRS Standards. She is also unwilling to reduce the profits of the group by properly applying the assets held for sale criteria in relation to Newall nor to create a restructuring provision. All of the adjustments required to ensure the financial statements comply with IFRS and IAS Standards will reduce profitability. It is true that the directors do have a responsibility to run the group on behalf of their shareholders and to try to maximise their return. This must not be to the detriment, though, of producing financial statements which are objective and faithfully represent the performance of the group. It is likely that the chief operating officer is motivated by bonus targets and is therefore trying to misrepresent the results of the group. The chief operating officer must make sure that she is not unduly influenced by this self-interest threat to her objectivity.

The chief operating officer is also acting unethically by threatening to dismiss the accountant should they try to correct the financial statements. It is not clear whether the chief operating officer is a qualified accountant but the ethical principles should extend to all employees and not just qualified accountants. Threatening and intimidating behaviour is unacceptable and against all ethical principles. The accountant faces an ethical dilemma. They have a duty to produce financial statements which are objective and fair but to do so could mean losing their job.



Tutorial note

Remember to discuss actions that the accountant should take.

The accountant should approach the chief operating officer and remind them of the basic ethical principles and try to persuade them of the need to put the adjustments through the consolidated accounts so that they are fair and objective. Should the chief operating officer remain unmoved, the accountant may wish to contact the ACCA ethical helpline and take legal advice before undertaking any further action.

Marking scheme		
		Marks
(a)	Subsidence as impairment indicator	2
	Fair value	2
	Allocation of impairment loss	1
	Held for sale criteria, valuation and impairment	3
	Required accounting treatment	3
		11
(b)	Discussion of ethical principles	2
	Application of ethical principles to scenario	5
		7
	Professional marks	2
Total		20

Examiner's comments

Candidates with good exam technique should briefly plan the content of their written answer to avoid repetition: writing the same point twice loses valuable time and certainly will not score marks twice. Good practice is to have separate headings for each 'situation', with lines left in between them for ease of marking.

Part (b) was well-answered in most cases, with better answers applying ethical principles to the scenario. It was pleasing to see fewer answers merely 'listing out' rote-learned ethical requirements in this sitting.



CLOUD Walk in the footsteps of a top tutor



Key answer tips

There are two professional marks awarded for the application of ethical principles. Make sure that your discussion of ethics relates to the specific circumstances and transactions in the question. Do not just regurgitate the ACCA Code of Ethics, but do have a think about what ethical principles Cloud's directors and staff might be breaching.

Presentation of loan in statement of cash flows



Tutorial note

Begin by defining the relevant categories of cash flows. Use these definitions to decide whether the cash receipt has been appropriately presented.

IAS 7 Statement of Cash Flows says that cash flows from operating activities are those related to the revenue-producing activities of an entity, such as cash received from customers and cash paid to suppliers. Cash flows from financing activities are those that change the equity or borrowing structure of an entity.

The cash received from the bank is a borrowing. As such, it should be reported as a cash flow from financing activities.

The current treatment is over-stating Cloud's operating cash flows, which is likely to make Cloud look more liquid than it really is. It may also improve perceptions of its long-term sustainability.

Share sale



Tutorial note

A profit or loss on the sale of shares in a subsidiary arises in the consolidated financial statements only if control is lost.

If a share sale results in loss of control over a subsidiary then a profit or loss on disposal should be recorded. If there is no loss of control then there should be no profit or loss on disposal and no remeasurement of goodwill. Instead the transaction is accounted for in equity, as an increase to the non-controlling interest (NCI).

Cloud has incorrectly recorded a profit on disposal in the consolidated statement of profit of loss. This is over-stating profits and should be removed.



Tutorial note

Use the figures to calculate the adjustments required to equity.

Cloud should account for an increase to the NCI. This will be calculated as the percentage of the net assets and goodwill sold to the NCI. This amounts to \$1.5 million ($5\% \times ($5m + $25m)$). The difference between the cash proceeds and the increase to the NCI is accounted for as an increase of \$0.5 million (\$2m - \$1.5m) in other components of equity.

Revaluation of property, plant and equipment

IAS 16 Property, Plant and Equipment states that revaluation gains on property, plant and equipment are recorded in other comprehensive income (OCI) and held in a revaluation reserve in equity (other components of equity). Revaluation losses are charged to OCI to the extent that a revaluation reserve exists for that specific asset. Any revaluation loss in excess of the balance on the revaluation reserve is charged to profit or loss.



Tutorial note

You need to work out the revaluation reserve created by the prior year revaluation. Any revaluation loss in excess of the reserve balance is charged to profit or loss.

At 31 December 20X0, there was a revaluation gain of \$4 million being the difference between the carrying amount of \$8 million ($$10m \times 4/5$) and the fair value of \$12 million. This revaluation gain would have been recognised in other comprehensive income and held in a revaluation surplus in equity.

At 31 December 20X1 the carrying amount of the asset before the revaluation was $9 \text{ million} (12 \text{ million} \times 3/4)$.

The revaluation loss is \$5 million (\$9m - \$4m). Of this, \$4 million should be charged to other comprehensive income because that is the balance in the revaluation reserve. The remaining loss of \$1 million should be charged against profit or loss. Cloud's error means that profits are currently over-stated by \$1 million.



Tutorial note

Some entities perform a reserve transfer in respect of the excess depreciation arising from revaluations. This policy is optional. If you need to consider the impact of a reserve transfer then it will be explicitly mentioned in the question.

Ethics

The directors have a responsibility to faithfully represent the transactions that the entity has entered into during the year. This is because various user groups rely on the financial statements to make economic decisions. Accountants are trusted as professionals and it is important that this trust is not broken. Therefore, it is vital that the principles outlined in the ACCA *Code of Ethics* are understood and followed.

The directors receive a bonus based on profits and operating cash flows. This might impair their objectivity when accounting for transactions that have taken place during the year.



Tutorial note

Make specific reference to the accounting errors that Cloud has made. These errors increase cash flows from operating activities and profit – what does that suggest?

The error in the statement of cash flows increased cash flows from operating activities. The errors relating to the share sale and the downwards revaluation of property, plant and equipment have over-stated profit for the year. It seems likely that the misstatements were deliberate in order to meet the bonus target.

It is unclear if it was the finance director who processed these incorrect accounting entries, or if it was other members of the accounts department. However, the other accountants still have an ethical responsibility not to mislead the users of the financial statements. It may be that they are intimidated by the dominant finance director. They should consider reporting any concerns to the other directors, if possible, or they could highlight these issues to the audit committee or the external auditors.

Of course, it may be that the misstatements were legitimate mistakes rather than a deliberate attempt to meet profit and cash flow targets. Nonetheless, accountants have a responsibility to ensure that they are professionally competent. Thus, possessing insufficient knowledge of IFRS and IAS Standards constitutes an ethical issue. If this is the case then the finance director and/or relevant members of the accounts department need to actively seek out opportunities to continue their professional development.

Marking scheme		
	Marks	
Cash flow classification - 1 mark per point	3	
Share sale – 1 mark per point	4	
Downwards revaluation – 1 mark per point	4	
Ethical implications – 1 mark per point	7	
Professional marks	2	
Total	20	



GARDEN Walk in the footsteps of a top tutor



Key answer tips

You score one mark for each valid point that you make - set out your work neatly so that you can keep track of whether you've written enough (or too little or too much) for each issue.

(a) Share-based payment



Tutorial note

Outline the rules regarding the accounting treatment of equity-settled share-based payments and then apply these to the information given.

The directors have been granted share-options so this is an equity-settled share-based payment transaction. According to IFRS 2 Share-based Payment, the expense should be based on the fair value of the options at the grant date, which is \$4 per option. The expense should be spread over the three year vesting period, based on the number of options expected to vest. One third of the vesting period has passed so the finance director is incorrect in stating that no expense should be recognised in the current financial year.



Tutorial note

Always show full workings for any calculations. That way you may still score some marks, even if you make a mistake.

The expense that should be recognised in the year-ended 30 November 20X6 is:

5 directors \times 600,000 options \times \$4 \times 1/3 = \$4 million.

An expense of \$4 million should be recognised in profit or loss and a corresponding entry made to equity. This will reduce the reported profits of Garden.



Tutorial note

Don't forget that any transaction with a director is a related party transaction. Disclosures are therefore required.

IAS 24 Related Party Disclosures requires that key management personnel, which includes all directors, are related parties of the reporting entity. With regards to key management personnel, an entity is required to disclose employee benefits, including share-based payments.

The directors' son



Tutorial note

Do the payments to the son of the two directors need to be disclosed? Identify the relevant provisions of IAS 24 and use them to explain why disclosure is or is not required.

Directors are key management personnel and therefore are related parties of the reporting entity. IAS 24 also says that the close family members of key management personnel would be related parties of the reporting entity. The definition of close family members includes children.

The son of the finance and sales directors is therefore a related party of Garden. The salary paid to him would need to be disclosed in a note to the financial statements. A statement could be made that the transaction is on market value terms as long as this can be substantiated.

Operating segments



Tutorial note

The retail outlets have been aggregated with the rest of Garden's trading operations. Is this correct? State the rules regulating when aggregation of operating segments is appropriate and then apply these to the scenario.

According to IFRS 8 *Operating Segments*, an operating segment is a component of an entity that engages in business activities, and which has discrete financial information available that is monitored by the entity's chief decision maker. It would therefore seem that the retail outlets are an operating segment.

Operating segments can be aggregated if they have similar economic characteristics. Such segments would normally have similar long-term margins and also be similar in terms of the products that they sell, the customers that they sell to, and the distribution methods used.

The retail outlets have a different margin to the rest of Garden's activities. Furthermore, the retail stores sell to customers face-to-face, whereas the rest of Garden's businesses is conducted online with goods despatched to customers via couriers. This suggests that the retail outlets do not have economic characteristics similar to the other operating segments. As such, the retail outlets should be disclosed as a separate segment (assuming they exceed the quantitative thresholds outlined in IFRS 8).

IAS 24 Related Party Disclosures says that a close family member of a director is a related party of the reporting entity. However, the definition of a close family member does not include friends. This means that the purchase of the trade and assets of the retail business should not be disclosed as a related party transaction.

(b) Ethical and professional issues

The purpose of financial statements is to give a faithful representation of the company's position and performance to enable investors, lenders and other users to make economic decisions. Accountants have a social and ethical responsibility to issue financial statements which do not mislead the public. Deliberate falsification of financial statements is unethical. Any manipulation of the accounts will harm the credibility of the profession since the public assume that professional accountants will act in an ethical capacity.

A faithful representation is normally deemed to have been provided if the financial statements are prepared in accordance with International Financial Reporting Standards. It would seem that the financial statements currently breach a number of key standards, such as IFRS 2 Share-based Payments, IAS 24 Related Party Disclosures and IFRS 8 Operating Segments.



Tutorial note

Make specific reference to the transactions in the question. What is the impact of the mistakes/omissions on the financial statements?

Omitting the share-based payment transaction from the financial statements has inflated profit for the year, which could impact shareholder perception of the underlying performance of Garden. Moreover, the shareholders have already been critical about director remuneration, so omitting the transaction may have been a tactic for deliberately concealing this additional benefit.

It would also seem that the recruitment and remuneration of the son of the finance and sales directors is being deliberately concealed. Although it is claimed that he is being paid a salary that is in line with market rates, questions may still be asked about the appointment, such as: Is this the best person for the job? Is this role really required? Is this the best use of company money? Some users of the financial statements might conclude that the directors are putting their own interests, and the interests of their family members, above those of the other company shareholders.

Garden's finance director has wrongly aggregated the entity's operating segments. This might be an attempt to hide the poor performance of the newly acquired retail outlets, thus avoiding further criticism and scrutiny of the transaction. Whilst the trade and assets were not purchased from a related party, the fact that the transaction took place with a close friend of one of the directors raises questions about integrity and the extent to which the directors more generally are effectively and efficiently using the entity's resources.



Tutorial note

Note that the question requires you to answer from the perspective of the accountant. Explicitly state the ethical principles that have been breached. Try and come up with practical steps that the accountant should take to resolve the ethical issues.

The accountant should remind the directors that professional ethics are an integral part of the framework from which professional accountants operate. They must adhere to ethical guidelines such as the ACCA's *Code of Ethics and Conduct*. It would appear that the financial statements are being deliberately manipulated, probably to avoid further criticism from shareholders about the running of the company and the stewardship of its assets. This would contravene the principles of integrity, objectivity and professional behaviour. Records of discussions between the accountant and the directors should be kept and, if disagreements remain, advice should be sought by the accountant from ACCA. If no effective channel for internal reporting of concerns exists then the accountant may need to consider resignation.

Marking scheme		
		Marks
(a)	Share-based payment	4
	Related parties	3
	Operating segments	4
		11
(b)	Discussion of ethical principles	2
	Application of ethical principles to scenario	5
		7
	Professional marks	2
Total		20

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CHERRY Walk in the footsteps of a top tutor



Key answer tips

There are two marks available for the application of ethical principles. To get these you should tailor your answer to the specific transactions in the question.

Do not write everything that you know about each accounting standard or you will run out of time. Instead, jot down the rules and principles that are relevant to the scenario and then apply these.

Remember that one mark is awarded per valid point that you make. Make sure that you are writing enough to pass.

(a) Change in accounting policy for pension scheme



Tutorial note

If an entity talks about changing its accounting policies then there will be marks available for referring to IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. Try and remember that entities can only depart from IFRS and IAS Standards if compliance would be misleading.

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors only permits a change in accounting policy if the change is:

- required by an IFRS Standard or
- results in the financial statements providing reliable and more relevant information.

A retrospective adjustment is required unless the change arises from a new accounting policy with transitional arrangements to account for the change.

It is possible to depart from the requirements of IFRS and IAS Standards but only in the extremely rare circumstances where compliance would be so misleading that it would conflict with the overall objectives of the financial statements. This override is rarely, if ever, invoked.



Use the relevant accounting standard, IAS 19 Employee Benefits, to explain why the directors' policy change is not allowed.

IAS 19 *Employee Benefits* requires all gains and losses on a defined benefit scheme to be recognised in profit or loss except for the remeasurement component which must be recognised in other comprehensive income.

The amendment to the pension scheme is a past service cost and must be expensed to profit or loss. Additionally, it appears that the directors wish to manipulate other aspects of the pension scheme such as the current service cost and, since the scheme is in deficit, the net finance cost. The directors are deliberately manipulating the presentation of these items by recording them in OCI rather than in profit or loss.

Trademark



Tutorial note

Don't rush into calculations. Easy marks are available for using IAS 38 Intangible Assets to explain why Cherry's treatment of the brand is incorrect.

IAS 38 Intangible Assets states an intangible asset with a finite useful life should be amortised on a systematic basis over that life. The amortisation method should reflect the pattern of benefits and it should be reviewed at least annually. A change in amortisation method is adjusted prospectively as a change in estimate under IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Expected future reductions in sales could be indicative of a higher rate of consumption of the future economic benefits embodied in an asset. Hence, the trademark should have been amortised over a remaining 2.5 year period (from 1 December 20X5 until 31 May 20X8).

At the date of the estimate change the trademark had a carrying amount of \$2.1 million ($\$3m \times 7/10$). The amortisation charge in the current period should have been \$0.84 million (\$2.1m/2.5 years). This means that Cherry's profits and intangible assets are currently overstated by \$0.54 million (\$0.84m - \$0.3m).

The correcting entry required is:

Dr Amortisation expense (P/L) \$0.54m

Cr Intangible assets \$0.54m



Tutorial note

Reducing the expected useful economic life of an asset is an indication that it might be impaired. You should discuss impairment, even though you are not given enough information to calculate it.

IAS 36 Impairment of Assets states that an entity should assess annually whether there is any indication that an asset may be impaired. If any such indication exists, the entity should estimate the recoverable amount of the asset. Thus, Cherry should test the trademark for impairment by comparing its carrying amount to its recoverable amount. The recoverable amount is the higher of fair value less costs to sell, and value in use. If the trademark is impaired then the current over-statement of Cherry's profits and assets is even greater.

Sale and leaseback



Tutorial note

Remember that lessees are required to recognise a right-of-use asset and a lease liability. Cherry has not done this. Comment on this to score some easy marks. The calculation of the correct profit on disposal is trickier. Revisit the Study Text if you cannot remember how to do this.

Sale and leaseback transactions are accounted for under IFRS 16 *Leases*. If the transfer of the asset represents a sale then the seller-lessee measures the right-of-use asset at the proportion of the previous carrying amount that relates to the rights retained after the sale. This means that the seller-lessee recognises a profit or loss based only on the rights transferred.

If the transfer does not qualify as a sale then the seller-lessee continues to recognise the underlying asset and will also recognise a financial liability equal to the proceeds received.

It would seem that the transfer does represent a sale because Cherry is only leasing the asset back for a fraction of its remaining useful life and so the buyer-lessor seems to have obtained control of the underlying asset.

Cherry must initially measure the right-of-use asset at 1.26 million ((1.8m/5m) × 3.5 million).

The lease liability will be initially measured at the present value of the lease payments, which is \$1.80 million.

Cherry has recorded a profit on disposal of \$1.5 million but this should have been 0.96 million (1.5m × ((5m – 1.8m)/5m). Therefore, the profit on disposal must be reduced by 0.54 million.

The correcting entry required is as follows:

Dr Right of use asset \$1.26m

Dr Profit or loss \$0.54m

Cr Lease liability \$1.80m

In the next reporting period, depreciation on the right-of-use asset and interest on the lease liability will be recorded in profit or loss.

(b) Ethics



Tutorial note

Make sure that you discuss why the directors are behaving unethically.

The current accounting treatments cannot be justified. The directors have an ethical responsibility to produce financial statements which are a fair representation of the entity's performance and position and which comply with all accounting standards. The errors made by Cherry under-state its liabilities and over-state its assets and profits.

There is a clear self-interest threat arising from the bonus scheme. The directors' change in policy with regards to pensions appears to be motivated by an intention to overstate operating profit to maximise their bonus potential.



Tutorial note

State the specific principles from the ethical code that the directors are breaching.

Such treatment is against the ACCA ethical principles of objectivity, integrity and professional behaviour.

The objectivity of the financial controller is also being compromised. The implicit threat to reduce her bonus would seem to give rise to both self-interest and intimidation threats.

The financial controller should remind the directors of their ethical responsibilities and should persuade them to change the current accounting treatment of all three of the transactions. If she feels she cannot discuss this with the directors then she should discuss the matters with the audit committee. The financial controller should document her discussions.

Marking scheme		
		Marks
(a)	Change in pension policy	3
	Intangible asset	4
	Sale and leaseback	5
		l
		12
(b)	Discussion of ethical principles	2
	Application of ethical principles to scenario	4
		6
	Professional marks	2
Total		20

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Key answer tips

This question requires knowledge of three key accounting standards – IFRS 9 *Financial Instruments*, IAS 32 *Financial Instruments: Presentation*, and IFRS 16 *Leases*. If you are unfamiliar with these, then you should revisit the Study Text. In Strategic Business Reporting, marks are awarded for demonstrating knowledge of the relevant accounting standards and also for applying this knowledge to the scenario.

When discussing the ethical implications remember that generic comments about the *Code* of *Ethics* will not score highly. You must explain the particular ethical issues facing Anouk and outline how the financial controller should address these.

Receivables



Tutorial note

Many students forget that receivables are a financial instrument and therefore make no reference to IFRS 9 Financial Instruments. However, you could still score well if you applied basic accounting principles to the scenario.

IFRS 9 *Financial Instruments* suggests that the trade receivables should be derecognised from the financial statements when the following conditions are met:

- There are no further rights to receive cash
- The risks and rewards of ownership have substantially transferred.

The factor has full recourse for a six-month period so Anouk still has the irrecoverable debt risk. Furthermore, Anouk has the right to receive further cash payments from the factor, the amounts to be received being dependent on when and if the customers pay the factor. Anouk therefore still has the risks associated with slow payment by their customers. As such, the receivables must not be derecognised from the financial statements on 31 December 20X1. Instead the proceeds of \$8 million $(20\% \times \$40m)$ should be treated as a short-term liability.

Accounting for the legal form of the transaction will understate receivables and understate liabilities. This makes it less likely that Anouk will break its loan covenants.

Debt or equity



Tutorial note

This is a very popular exam topic. It is essential to memorise the definitions of equity and financial liabilities.

IAS 32 Financial Instruments: Presentation uses principles-based definitions of a financial liability (debt) and of equity. The key feature of debt is that the issuer is obliged to deliver either cash or another financial asset to the holder. The contractual obligation may arise from a requirement to repay principal or interest or dividends. Equity is any contract which evidences a residual interest in the entity's assets after deducting all of its liabilities. A financial instrument is normally an equity instrument if the instrument includes no contractual obligation to deliver cash or another financial asset to another entity (such as ordinary shares).

Anouk's decision to classify B-shares as non-controlling interests is incorrect. Anouk has a clear contractual obligation to buy B-shares from the non-controlling interest under agreed terms and does not have an unconditional right to avoid delivering cash to settle the obligation. The minority shareholders' B-shares should therefore be treated as a financial liability in the consolidated financial statements.

The current treatment of the B shares over-states Anouk's equity and understates its liabilities. This makes it less likely that Anouk will break its loan covenants.

Crane contract



Tutorial note

It is important that entities correctly identify a contract that contains a lease because lessees are required to recognise a liability and a right-of-use asset in respect of all leases (unless short-term or of low value).

IFRS 16 Leases says that a contract contains a lease if it 'conveys the right to control the use of an identified asset for a period of time in exchange for consideration' (IFRS 16, para 9). To have control, the contract must give the customer the right, throughout the period of use, to:

- substantially all of the identified asset's economic benefits, and
- direct the identified asset's use.

Although the crane used by Anouk can be substituted, the supplier is unlikely to benefit from this due to the costs involved. Therefore it can be concluded that Anouk has the right to use an identified asset over the contract term.

Anouk has the right to direct the use of the crane because it decides how the crane will be used. The restriction on operating during high winds, as outlined in the contract, defines the scope of Anouk's use, rather than preventing Anouk from directing use. Therefore Anouk controls the Crane over the period of use.



Tutorial note

Do not stop once you have concluded that the contract contains a lease. You need to discuss the correct accounting treatment.

Based on the above discussion, it would seem that the contract contains a lease. A lease liability should have been recognised at the commencement of the lease for the present value of the payments to be made. A right-of-use asset should be recognised for the same value, plus any associated direct costs.

Anouk has posted no accounting entries and so is currently understating both its assets and liabilities. Once again, this makes it less likely that the loan covenants will be breached.

Ethics

It is important that stakeholders of a company can rely on financial statements to make informed and accurate decisions. The directors of Anouk have an ethical responsibility to produce financial statements which comply with accounting standards, are transparent, and are free from material error.



Tutorial note

Make specific reference to the errors in Anouk's financial statements.

The current accounting treatment of all three transactions understates Anouk's reported liabilities. The current accounting treatments, if uncorrected, may mislead Anouk's stakeholders. Any adverse publicity could lead to a loss of public trust in the accounting profession.



Tutorial note

Make specific reference to the ethical principles that the directors are breaching.

It would seem likely that the directors are deliberately circumventing the terms of the covenants, particularly as they have concealed documents from the financial controller. Such actions are a clear breach of the fundamental principles of objectivity and integrity as outlined in the ACCA *Code of Ethics and Conduct*.



Tutorial note

Outline practical steps that the financial controller should take to resolve the issues.

The financial controller should remind the directors of their ethical responsibilities and remind them that Anouk's financial statements must fully comply with accounting standards. Records of these discussions should be kept. If disagreements remain, the financial controller should seek advice from ACCA. The financial controller may need to consider resignation if no effective channel for internal reporting of concerns exists.

Marking scheme		
	Marks	
Receivables and factoring – 1 mark per point	4	
Debt or equity – 1 mark per point	4	
Lease contract – 1 mark per point	4	
Ethical implications – 1 mark per point	6	
Professional marks	2	
Total	20	

SECTION B

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



Key answer tips

This question tested knowledge of two main standards - IFRS 16 Leases and IAS 28 Investments in Associates and Joint Ventures. Assuming the candidate's knowledge of the basics of these topics is to the required standard, this question could provide some achievable marks. There is quite a lot of data to process so, as always, watch your timing. However, many of the significant figures have been provided directly in the question without the need for time-wasting calculations. Use this to your advantage.

(a) Company cars



Tutorial note

This requirement asks for consideration of the effect on 3 areas of the financial statements (EBITDA, profit before tax and the statement of financial position) caused by 3 separate methods of financing the provision of company cars to its staff. This gives 9 distinct tasks to address. If candidates can address all 9 tasks in their time allocation then, with a mark allocation of 13, a score of at least 9/13 should be well within reach. Focus on providing an answer that addresses each required task within the time. The risk here is that candidates exhibit poor time-management by extensively discussing only 1 or 2 of the financing options.

Option 1: Leased for a four-year period



Tutorial note

Get the basics across for a lease – initial recognition and subsequent treatment of the right of use asset and lease liability.

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

Option 2: Purchased on 1 January 20X7

If the cars were purchased on 1 January 20X7, then depreciation of \$11,380 (\$75,274 - \$29,753 = \$45,521/4 = \$11,380) would be charged and interest of \$3,764 (\$75,274 \times 5%) would also be charged. The cars would have to be serviced at a cost of \$2,820.



Tutorial note

For option 2 discussion of the initial recognition of the vehicles (at cost) as per IAS 16 Property, Plant and Equipment, and the loan liability measured at amortised cost per IFRS 9 Financial Instruments is likely to achieve marks as well.

Option 3: Leased on a 12-month agreement



Tutorial note

State the rules for the 12-month lease and apply them to the scenario.

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

- (i) leases with a lease term of 12 months or less and containing no purchase options, and
- (ii) leases where the underlying asset has a low value.

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

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



Tutorial note

The approach in the official answer deals firstly with the accounting issues for each option, then considers the resulting impacts on the requested financial indicators (as below). Do not worry if you have used an alternative approach, such as, for each option, addressing the accounting treatment and the impacts on the financial information together, as this would be equally acceptable.

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

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

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

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

Option 1:	Option 2:	Option 3:
Lease over 4 years	Purchase with loan	12-month leases
(\$)	(\$)	(\$)
100,000	100,000	100,000
(2,820)	(2,820)	
		(22,800)
97,180	97,180	77,200
(12,701)	(11,380)	
(2,274)	(3,764)	
82,205	82,036	77,200
	(\$) 100,000 (2,820) 97,180 (12,701) (2,274)	Lease over 4 years Purchase with loan (\$) (\$) 100,000 100,000 (2,820) (2,820) 97,180 97,180 (12,701) (11,380) (2,274) (3,764)

Statement of financial position

PPE	38,102	63,894	0
	(50,803-12,701)	(75,274-11,380)	
Lease/Loan Liability	39,061	79,038	0
	(see explanation)	(75.274 + 3.764)	

(b) (i) Equity method



Tutorial note

Make sure you answer both parts of the requirement here. It is easy to forget to compare the equity method used for an associate to using the cost or fair value. Do not be afraid to provide your own opinion regarding the relevance of the equity accounting treatment, even if your opinion seems to contradict the preferred option of the standard. As long as you justify your stance, a conclusion of some sort is better than no conclusion at all!

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

(ii) Emphasis Co



Tutorial note

This requirement calls for a discussion of the classification of Emphasis Co as a joint venture and the accounting of the shareholding in Emphasis. The classification part should provide some relatively easy marks for those that had studied the fundamental concepts surrounding joint ventures.

The following are the characteristics of a joint venture:

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

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

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



Tutorial note

The accounting element includes a tricky issue where the joint venturer initially contributes less than the proportionate fair value of the net assets of the joint venturer. If you found yourself struggling with the bargain purchase, have a guess (there's no negative marking), but make sure you prioritise the classification element, where marks for the fundamentals will be awarded.

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

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

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

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

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

Examiner's comments

a) Part (a) appeared surprisingly challenging for candidates, which is concerning given 13 marks were available for this, and the area of leases is examined relatively often. Much of it was assumed knowledge from Financial Reporting and we would have expected strong application of this knowledge.

Some candidates incorrectly treated the transactions as if the company were leasing cars to managers rather than leasing cars for the managers' use. Even with this misinterpretation, a good description of the principles and underlying treatment of each option would still earn marks.

The question provides sufficient detail for candidates to use the spreadsheet function to calculate the accounting treatments for options 1 and 2, and then summarise the impact of all three options on the three aspects (EBITDA, profit before tax and the statement of financial position). Present values were provided, so in the case of option 1, candidates needed only to calculate the unwinding of the lease liability and depreciation of the right of use asset for the first year. No implicit interest rate is provided, nor required. Instead, the question tells us the correct amount of interest for the year. The monthly payments and service charge element within this amount are also provided, so the closing lease liability can be calculated once annual amounts are worked out.

For option 2, the calculations were simpler since the cars' fair value and residual value, and the implicit interest rate of the loan are all provided. Candidates needed only to work out the depreciation charge, using the stated residual value and interest charge, given no repayment was made until the first day of the following year. This is FR level knowledge and should have been straightforward. For option 3, the annual cost is the only calculation.

The weakest part of most answers was the description of the impact of each option on EBITDA, profit before tax and the statement of financial position. A good answer would use a table approach, in which the impact on each aspect could be shown succinctly.

Note how this presentation separates EBITDA, which is not impacted by depreciation or interest, from profit before tax. Candidates should link the figures included in the above table to their previous workings, to save time and avoid errors. Once complete, a description of the impact of each option on each aspect of the financial statements is a much simpler task. Unfortunately, too many answers did not make sufficient use of the spreadsheet functions available. In a surprisingly high number of cases the spreadsheet was not used at all. Presentation in these cases was very weak; with answers limited to note form or without any structure, and with little attempt to present workings in a way that could be understood.

In some cases, candidates did not seem to know what EBITDA was despite it being written out in full in the requirements; and a number of answers excluded any calculations or explanation of the impacts on EBITDA, profit before tax and SOFP. Whilst calculations were not explicitly required in the question (which asked for an explanation), these aided the explanation of the impact, and most answers provided calculations. Candidates who did not achieve high marks in this question need to be much more familiar with the advantages of answering it using the spreadsheet function. The accounting profession expects the use of spreadsheets at a high level, and candidates need to consider not only the use of formulae to save time, but also an appropriate layout of a spreadsheet working. A worrying number of answers did not use the formula function at all or presented their workings poorly, making it hard for the marker to follow, or impossible to mark without suitable workings and explanation. It is vital for candidates to avoid treating the spreadsheet as a word processor.

b)i) This part had only four marks and required no reference to the scenario. As such, it provides an opportunity for candidates to show their knowledge of the equity accounting measurement method, and to compare this with the cost or fair value measurement bases. Good answers would describe the need for significant influence (as opposed to control) and the principles that apply where such an influence exists.

To gain good marks, candidates should ensure they have met all the requirements of the question. Whilst most candidates described the equity method and the underlying accounting principles, fewer then contrasted this sufficiently to the cost and fair value measurements and where these may be more useful to the users. Those that did not provide answers to both limited their opportunity for marks.

b)ii) This requirement continues the theme of part (b)(i) by requiring a discussion as to whether the newly-formed legal entity (Emphasis Co) should be classified as a joint venture, and how it should be accounted for at the date of formation. The majority of candidates scored well in explaining the characteristics of a joint venture, and then discussed why this applied to Emphasis Co.

Good answers would have identified that whilst the 20% holding only appointed one board member, this member was key as it can prevent the other two parties from making significant decisions - without that member's consent decisions are not unanimous. Weaker answers incorrectly identified Emphasis Co as an associate, focusing on the 40% holding rather than the other characteristics of the agreement.

The accounting method was therefore to apply the equity method under IAS 28 Investments in Associates and Joint Ventures. Under IAS 28, where there is a difference between the investment in the joint venture and the share of the fair value of its net assets, this is accounted for like goodwill (in accordance with IFRS 3 Business Combinations). In this case, a bargain purchaseis recorded as a gain in earnings on the investment date. Few candidates identified this bargain purchase, and also made no comments relating to the need to reassess whether all identifiable assets and liabilities are identified (since bargain purchases are rare). A simple calculation of the gain would have maximised potential for marks. Generally, if given figures in a scenario, candidates are expected to use them in their answer.

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



Key answer tips

Another SBR examination question featuring contemporary issues- this time crypto assets and ICOs. A number of recent technical articles have been written on these subjects, so please take note of their examinability.

The financial reporting scenarios in requirements (b-d) are difficult and candidates are unlikely to feel confident as they produce their answers. Use the mark allocations to help with the timing. Address the requirements and follow the specific tips outlined in the tutorial notes.

(a) Principles of good disclosure



Tutorial note

If you're not feeling confident when attempting a current issues discussion question like this one, it is important that you do not give up entirely. Not all answers need detailed technical knowledge. For tasks like this, the examiner wants to see indications that you have properly considered the practical implications presented by the issues raised for accountants in practice. Common sense points relating to the purpose of disclosures in general can be applied to this question. Disclosures should provide useful information, be entity-specific, concise, highlight important matters and should consider materiality. Application of these general disclosure points to the issue of crypto assets will ensure candidates score well.

This requirement carries 2 professional marks. Candidates must attempt the question fully to give the marker the chance to award these marks. If you give up, you'll throw those marks away too.

It is also important to note that these answers are not exhaustive. Relevant points made that may not be represented within this published answer will still score marks. Therefore, within your time allocation, make as many sensible points as possible. You may do better than you think. However, one thing is for sure, a blank answer will score zero!

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

The information about crypto assets should be linked when relevant to other information in the financial statements or to other parts of the annual report to highlight relationships between pieces of information and improve navigation through the financial statements. Commodity broker-traders holding crypto-assets as inventory at fair value less costs to sell, in addition to the general IAS 2 *Inventories* requirements, will need to disclose the carrying amount of such inventories carried at fair value less costs to sell. In addition, IFRS 13 *Fair Value Measurement* disclosure requirements for recurring fair value measurements would also apply. The information about crypto assets should be provided in a way which optimises comparability among entities and across reporting periods without compromising the usefulness of the information. Holders of crypto assets classified as intangible assets

under IAS 38 Intangible Assets will need to disclose, by class, a reconciliation between the opening and closing carrying amounts, whether the useful life is assessed as indefinite, and, if so, the reasons supporting the indefinite useful life assessment, and a description of individually material holdings.

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

(b) Development costs



Tutorial note

Candidates must apply the principles of IAS 38 Intangible Assets to the development and promotional costs associated with the unusual situation of the ICO of Symbal. However, be aware that judgement should be applied and a definite conclusion may not always be possible based upon the information provided. Weighing up the treatment whether or not the costs meet the definition of an intangible asset will help provide further facets to an answer.

Also, it is worth noting that similar conclusions can be made if the candidate applied the definition of an asset, as outlined within the Conceptual Framework. This alternative viewpoint may help a candidate arrive at a valid conclusion even if their specific knowledge of IAS 38 falls short.

If the costs do not satisfy the requirements of IAS 38 they are recognised as expenses. The costs satisfy the requirements for recognition of intangible assets if, and only if, it is probable that the future economic benefits which are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably. The probability of future economic benefits must be based on reasonable and supportable assumptions about conditions which will exist over the life of the asset.

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

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

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

(c) ICO arrangements



Tutorial note

Another tricky scenario that candidates are unlikely to feel confident attempting to answer. My advice is to keep your answer structured and as simple as possible.

Keep the answer structured by using the requirement to your advantage. The requirement explicitly mentions the \$1m pre-sale agreement, and the \$10m raised by the ICO. Effectively identifying these transactions as separate issues to consider. Tackle them one at a time and use sub-headings to make it easier for the marker to spot that you have addressed each issue.

If you are struggling to find a standard that fits the bill, fall back on the definitions of the elements of the financial statements as identified within the Conceputal Framework. This may help to develop a conclusion.

Year ended 31 March 20X7

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

Year ended 31 March 20X8

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

Dr Bank \$10 million

Cr Other financial income \$10 million

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

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

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

(d) Tokens granted to directors



Tutorial note

The requirement here helps by confirming that IFRS 2 is not appropriate and clarifies that Symbal should be applying IAS 19 Employee Benefits. This provides a basic structure to the answer – discuss why IFRS 2 is not relevant (the scenario provides plenty of indicators that the tokens are not shares, therefore the tokens cannot be a share-based payment) and discuss why IAS 19 is relevant.

The dates involved are short term, therefore the tokens are equivalent to a bonus for the directors and are accrued for.

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

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

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

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

Thus, at 31 March 20X7

Dr Employee costs \$250,000

Cr Short-term employee benefit liability \$250,000

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

Examiner's comments

This question scenario was based around a contemporary issue in financial reporting and referred to in the SBR syllabus under current issues as broadly 'accounting for digital assets'. This area of the syllabus has been specifically created in response to employers wanting to employ candidates who understand new concepts in this digital age. However, much of the question was not specifically about digital assets or indeed the Initial Coin Offering (ICO) but examined wider issues, like the principles of good disclosure, the recognition criteria of IAS 38 *Intangible Assets* and IAS 19 *Employee Benefits*. It was disappointing that so many candidates could not apply their financial reporting knowledge to the given scenario. Instead they often focussed exclusively on crypto currency, choosing to discuss everything they knew about crypto currencies without specific application to the requirement. This gained few, if any marks.

It is also worth stating that the scenario provided a diagram that illustrated in simple terms the relationship between the investors in an Initial Coin Offering (ICO) and Symbal Co who issued the tokens and managed the trading platform. This was designed to assist candidates and sat alongside the narrative description of the relationships shown in the diagram. There are also recent technical articles written by the SBR examining team specifically covering Initial Coin Offerings and crypto currencies so candidates should have been prepared to see them in an SBR exam. We have always stressed to learning providers and candidates that it is vital that candidates read the articles produced by the examining team. However, we would reiterate that although the scenario was deliberately relevant and current, as candidates should expect, it was examining other core syllabus areas and not just digital assets.

a) This part of the question required candidates to simply explain the principles of good disclosure and apply them to crypto assets. The candidates were told they did not need to refer to any exhibit as it was a high level discussion that was expected and required. It was uncomplicated and marks were awarded for basic principles.

Good candidates were able to match basic disclosure principles disclosures with the challenges brought by crypto assets and their relatively recent rise to prominence. There were, encouragingly, many candidates who advised treatment as intangible assets as opposed to cash or investments. Marks were awarded for this despite not being specifically asked for as it was relevant. The published answer does not cover all the points that could be awarded marks, but credit was given for appropriate discussion of the principles of good disclosure, which may have been IFRS standard specific.

Weaker candidates tended to list out everything they knew about crypto assets without actually addressing the requirements. Some candidates simply regurgitated the article on crypto currency without any application at all and certainly no mention of what constituted good disclosure. This type of rote learned knowledge will never be sufficient to score well in an SBR exam and will always severely restrict any marks that can be awarded. As the 2 professional marks were awarded here, those who did not address the required disclosure aspect lost these marks.

- b) This part of the question required candidates to discuss the basic principles of IAS 38 *Intangible Assets* and apply them to the costs of setting up an ICO. The candidate did not therefore need to understand an ICO to be able to apply basic knowledge and principles of IAS 38, much of which is assumed knowledge from Financial Reporting level. The principles are the same whatever the context and scenario. There were some very good answers which separated out the development and promotional costs and their differing treatment. Weaker answers often treated all the elements identically or just listed out the definition of intangibles from IAS 38.
- c) This part of the question was answered poorly by many candidates. The question required candidates to deal with an advanced payment for tokens to be issued in an ICO and then how to treat the receipt of monies received from an ICO. This recent technical article may have helped some candidates however application of basic principles to the scenario should have been sufficient to score well.

Candidates did not have to have any in-depth understanding of an ICO, just to apply basic principles to discuss how the proceeds should be recognised, i.e income, liability or equity. Many candidates were unable to do this and omitted answers altogether. This is becoming an increasing issue with the SBR exam, in that candidates cannot apply principles to a scenario, familiar or otherwise. There were many signposts provided in the scenario for example 'no other rights such as redemption or any residual interest'. This should have been a clear steer that the tokens and monies raised are neither a financial liability or equity but instead would be recognised as income. Further discussion on the financial obligation to repay the \$1million received credit as did discussion of the principles of a contingent liability and financial liabilities with regards the payment of 10% profit to token holders. Many candidates treated the initial \$1m receipt as a sale and then ignored the remaining element of the transaction or treated it as equity. Candidates have problems generally with dealing with the difference between revenue and equity. Better candidates applied the principles of IAS 37 Provisions, Contingent Liabilities and Contingent Assets and realised that there was a contingent liability. A few candidates did mention how the transaction should be treated in the second year (20X8) too and they earned higher marks.

d) Despite the question specifically stating that the tokens would be treated as part of IAS 19, many candidates described the different types of share-based payments and then just added either no comment or a single line in relation to employee benefits. This part of the question generated very poor answers overall despite the fact that the requirement provided these clear signposts. The SBR exam increasingly details specifically the IFRS standards that are to be applied to the scenario. Choosing to ignore this will mean any marks awarded must be restricted. It would be useful for both candidates and tutors to be mindful of this.

35



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



Key answer tips

This question requires application of a range of core IFRS Standards, most notably IFRS 15 Revenue from Contracts with Customers, IAS 38 Intangible Assets, IFRS 16 Leases and IFRS 13 Fair Value Measurement to a modern, technology-driven industry. It also drew upon a less commonly tested standard, IAS 27 Separate Financial Statements.

Remember to state the relevant rules from the core standards for some easy marks.

(a) (i) Software contracts and updates



Tutorial note

As is the current exam trend, the scenario focuses on a modern phenomenon of licencing software. Despite this contemporary setting, candidates should follow a well-worn exam approach – state the rule and then apply the rule.

Application to the situation of IFRS 15 fundamentals such as identifying the performance obligation and recognising revenue over time will score well.

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

- the customer can benefit from the good or service either on its own or together with other resources, and
- the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

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

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

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



Tutorial note

This is another example where conclusions that are different to those made in the model answer can still score well. You will be awarded marks for any wellargued points you make.

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

(ii) Cent Co - why no intangible or lease?



Tutorial note

Read the requirement properly here – the perspective has shifted from Sitka Co to Cent Co.

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

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

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

(b) Part-disposal of Martett Co



Tutorial note

Even without detailed knowledge of the specifics of IAS 27, you would be able to reach reasonable conclusions using common sense (on disposal, a gain or loss will be recorded) or by drawing on knowledge from other standards (e.g. IFRS 9 Financial instruments). Don't worry if you're not mentioning all the technical points from IAS 27 referenced here.

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

- at cost
- in accordance with IFRS 9 Financial Instruments
- using the equity method as described in IAS 28 Investments in Associates and Joint Ventures.

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

- the fair value of the retained interest and any proceeds from disposing of a part interest in the associate or joint venture, and
- the carrying amount of the investment at the date the equity method is discontinued.

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

(c) Acquisition of Billings



Tutorial note

IFRS 13 Fair Value Measurement takes a market perspective. Therefore, the highest and best use must be taken from the perspective of those operating within the specific industry.

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

	ACCA marking guide	
		Marks
(a) (i)	(i) Discussion and application of the following to the scenario:	
	IFRS 15	2
	Updates of software	3
	Single performance obligation	1
	Revenue allocated over time	1
	Cannot use residual value	1
		8
(a)	(ii) Discussion and application of the following to the scenario:	
. ,	IAS 38	2
	IFRS 16	1
	Service contract	1
		4
(b)	Discussion and application of the following to the scenario:	
	IAS 27	2
	IFRS 9	3
	IAS 28	2
	Calculation of profit or loss	1
	Principles of OCI	1
		9
(c)	Discussion and application of the following to the scenario:	
	IFRS 13 highest and best use	2
	Grouping of fair values	2
		4
Total		25

Examiners comments

- (a) (i) 8 marks were available here, so your answer should be sufficiently detailed to earn these marks, whilst applying the guidance in IFRS 15 Revenue from Contracts with Customers for identifying distinct performance obligations. Since the determination of whether the licence and updates are separate performance obligations requires judgement, a good answer would discuss both sides of the argument. However, this was not necessary to gain maximum marks so long as the answer fully explained the rationale for either a single performance obligation or for two separate ones. Marks were available for calculations of revenue, provided they were supported with a valid argument.
- (a) (ii) The requirement to part (a) (ii) asked for an explanation as to why the right to receive access to the software was unlikely to be an intangible asset or a lease. Both items require explanation: why the right is not likely to be an intangible asset, nor a lease.

Given there are four marks available, this suggests two marks for each. It may help if your answer is split into two sections (intangible asset and lease).

- (b) had 9 marks available including marks for the calculation of the disposal gain. The first part of the question (on the disposal of the 45% interest) was not as well-answered as the subsequent measurement of the 15% interest. Many answers approached this first part from a group perspective, despite the question stating the need to discuss accounting treatment in the separate financial statements of Sitka Co. This meant applying IAS 27 Separate Financial Statements, and the question referred to this, as well as stating that the company had elected to measure the investment using the equity method. Be sure that you read the question scenario carefully before starting your answer. Calculation of the disposal gain was generally well-answered. Most candidates accounted for the subsequent measurement of the 15% interest in line with IFRS 9 Financial Instruments (measurement at fair value). However, few answers discussed the election at initial recognition to present changes in fair value in other comprehensive income (if not held for trading).
- (c) Most answers included a definition of fair value according to IFRS 13, and then applied the principle of highest and best use. Fewer answers then expanded further on applying this principle to the group of assets/liabilities within which the asset would be used, rather than individually, and how this lead to the highest and best use.



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



Key answer tips

This question combined the interpretation (in the sustainability requirement (a)) and the current issues (through the consideration of the impacts of natural disasters tested in (c)).

The interpretation requirements will always have 2 professional marks associated with them, making it extra important to attempt that part!

(a) Sustainability



Tutorial note

The requirement specifically states that there is no need to use the exhibits to answer this requirement. So don't make things hard for yourself by trying to link the content in the scenario. The exhibits are provided for later requirements.

Make sure you answer the question! Tell the examiner how sustainability is important to investors. Do not simply provide a generic answer here – meaning do not just discuss everything you know about sustainability reporting, with no context. By addressing the specific context of the requirement (the investors perspective), you will guarantee a good mark and ensure you grab those elusive professional marks.

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

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

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

(b) Impairment



Tutorial note

The old tutor mantra of 'read the requirement properly' is applicable here.

To score marks, you must address the **factors** indicating impairment. You do not need a detailed description of the accounting for potential impairments or an impairment calculation. Always answer the question set!

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

(c) (i) Destruction of the non-current assets and decommissioning of the power plant

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

(ii) Environmental damage and government compensation

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

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

(iii) Hedge of commodity price risk in aluminium



Tutorial note

IFRS 9 states that, to apply hedge accounting to forecasted hedge items, the transactions must be highly probable to occur. If the transactions are no longer highly probable, hedge accounting cannot be applied.

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

(iv) Potential insurance policy proceeds



Tutorial note

This question relies heavily on knowledge of IAS 37 Provisions, Contingent Liabilities and Contingent Assets. This is a standard that you would have first encountered in the ACCA Financial Reporting (FR) paper. Prior learning is crucial within the SBR examination and comes up regularly. Make sure you know your FR standards.

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

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

		ACCA marking guide	
			Marks
(a)		ussion of:	
	integ	gration of sustainability issues	4
			4
(b)	Discu	ussion of impairment indicators	2
(~)	Conclusion		
			3
(c)	(i)	Discussion and application to scenario:	
		Derecognition of NCA	1
		Change in accounting for decommissioning	3
			4
			4
	(ii)	Discussion and application to scenario of liability for environmental	2
		damage	
		Government grant	2
	/:::\	Discussion and application to scanario.	4
	(iii)	Discussion and application to scenario: Hedged transaction	2
		Accounting treatment	2
		, assuming to summer	
			4
	(iv)	Discussion and application to scenario:	
		Contingent asset	2
		Disclosure	2
			4
Profes	sional n	narks	2
Total			25

Examiners comments

- a) The question starts with a 4 mark requirement (a) to discuss why sustainability is important to an investors' analysis. It was clearly stated that there was no need to refer to the scenario in this section, and most answers followed that guidance. Referring to the scenario risks answering subsequent parts of the question, so it is recommended that candidates use the advice and stick to a general discussion. Better answers focused on the investors' perspective, and how sustainability information can enhance the more quantitative "traditional" financial statements. Fewer answers considered how sustainability information can be used to rank or rate potential investments or be a deciding factor in otherwise identical investments.
- b) This part was well-answered, and there were a number of events within the scenario which could have been used to illustrate the need. Most candidates scored full marks by identifying and explaining the importance of three key external indicators: a fall in demand, a fall in share price and the implications of storm damage.
- c) asked for a discussion of four events described in the scenario. Each was awarded 4 marks, so time spent on each item should have been allocated evenly. Doing so may have helped in your time management: this question is often the last attempted and therefore time may be constrained.

For (c) (i), two issues were raised (logically each earning 2 marks): the destruction of the non-current assets and decommissioning of the power plant. Whilst answers were generally good, some incorrectly suggested impairing the destroyed assets, which would be irrelevant since there would be no value in use nor net selling price. Decommissioning costs were often correctly identified as a provision, although some answers failed to discuss how the provision would be added to the carrying amount of the asset once the obligation arises (on commencement). Most answers picked up on the need for a change in depreciation (prospective adjustment), although fewer recognised the impact of the shorter life on the present value of the decommissioning liability.

Part (c) (ii) related to the cost of repairing environmental damage and the potential receipt of government compensation. These are two separate issues, so are likely to be awarded 2 marks each. Whilst most answers identified that there was no legal obligation for the environmental repairs, fewer considered whether a constructive obligation existed given past behaviour. The difference in scale and the fact that no announcement or valid expectation was raised means this is not likely to be a constructive obligation. Accounting for the government grant was less well-explained as some answers suggested disclosure despite there being no evidence of probable receipt (confirmation of receipt of application is not a confirmation that the grant will be paid, and the question states 'no approval'). Contingent assets require probable receipt for disclosure, and this aspect is also covered in (c) (iv). Fewer answers explained how, under IAS 20 Accounting for Government Grants and Disclosure of Government Assistance, a grant is only recognised when reasonable assurance is gained that any attached terms have been complied with and that the grant will be received.

For part (c) (iii), required discussion over the treatment of the hedging of commodity price risk in aluminium. This part was often the least well-answered and the shortest, despite also having 4 marks available. Whilst most answers correctly suggested derecognition of the hedge, any further knowledge of the correct hedge accounting was often weak. Answers often overlooked the accounting treatment prior to the disaster, and how after the disaster (and after derecognition) accumulated gains would need reclassifying from OCI to profit or loss.

Part (c) (iv) required a discussion on potential insurance policy proceeds. There were two situations for insurance claims with differing outcomes at the date of financial statement approval, and both should have been covered to increase potential for the 4 marks. Candidates in general were aware of the need to distinguish between the claim for the non-current asset losses (whose receipt post-reporting date was probable), and the two other claims for relocation costs and lost revenue (for which significant uncertainty existed). However, the recommended treatment of each was mixed. For the non-current asset loss, some incorrectly suggested recognition (contrary to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) rather than disclosure. Very few explained that virtual certainty is required for recognition (in which case IAS 37 no longer applies). Likewise, many answers suggested the claims with significant uncertainty could be disclosed as a note, rather than not being disclosed. These are quite fundamental and suggest a lack of knowledge of aspects of IAS 37 relating to contingent assets. Better answers began with a clear description of the requirements under IAS 37, and then applied these to the different claims.

37



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



Key answer tips

This question requires application of a range of core IFRS Standards, most notably IAS 36 Impairment of Assets, IAS 38 Intangible Assets and IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. Remember to state the relevant rules from the standards for some easy marks. Do not worry if your conclusion is different from the model answers you will be awarded marks for any well-argued points you make.

(a) IAS 38 Intangible Assets



Tutorial note

There are many different ways of approaching this question – any well discussed point will score one mark.

You might have concentrated on issues to do with identifying intangibles, or recognising internally generated intangibles. Alternatively, you might have spent more time discussing the difficulty involved in determining amortisation rates, or fair values, or value-in-use amounts for impairment review.

Below is a selection of comments that would be credit worthy.

The importance of intangible assets is reflected in the increasing proportion of a company's market value being attributable to them. However, there are many challenges involved in recognising and measuring intangible assets, such as brands, in the statement of financial position.

According to IAS 38 Intangible Assets are recognised at cost. For purchased intangibles, this is easy to determine. However some intangible assets, including many brands, are internally generated. IAS 38 prohibits the recognition of internally generated intangible assets (except those arising from development activity) because the cost of the asset cannot be determined.

Once an intangible asset has been recognised, it can be measured using a cost model (cost less amortisation and impairment) or using a revaluation model (fair value less amortisation and impairment).

Whichever model is used, determining the useful life of intangible assets is often subjective.

Many intangible assets are not traded on a stand-alone basis and so there is rarely an active market for them. This makes it difficult to determine a fair value. For these intangible assets, IAS 38 prohibits the revaluation model.

IFRS 3 Business Combinations

It was noted above that internally generated brands are not recognised in the statement of financial position. One exception to this rule is a business combination. If a company acquires control over another company, IFRS 3 *Business Combinations* requires that the subsidiary's identifiable net assets at the acquisition date are measured in the consolidated financial statements at fair value – even those that have not been recognised in the subsidiary's separate financial statements. Many intangible assets are unique and therefore it is not easy to identify and assess their value. Valuation methods are often complex and subjective and the measurement is more subjective when the intangible assets are not based on legally enforceable rights. In some cases, the acquirer does not intend to use the intangible assets (for example, Corbel has acquired brands for defensive reasons) and this raises further issues with regards to arriving at a value.

(b) (i) Jengi brand



Tutorial note

State the rule and then apply the rule.

IFRS 3 *Business Combinations* says that the acquirer must recognised identifiable intangible assets acquired in a business combination separately from goodwill. To be identifiable, the asset must be separable or arise from contractual or legal rights.

The Jengi brand is intangible because it has no physical substance. It meets the definition of an asset because it has the potential to generate future economic benefits by increasing sales volumes and the ability to charge premium prices. Brands are separable because they can be disposed of. As such, the brand is a separable intangible asset and must be recognised separately from goodwill.

Cash generating units



Tutorial note

Start with the definition of a cash generating unit.

IAS 36 Impairment of Assets defines a cash generating unit (CGU) as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or other groups of assets. As such, brands rarely qualify as a separate CGU.

The brand is most likely to qualify as a corporate asset. This is because it does not generate cash flows independently of other assets, but is also not attributable to just one single cash generating unit. Instead, it provides benefits across the business.

This means that the brand should be allocated to each of Corbel Co's cash generating units that are expected to benefit from the synergies of the combination.

(ii) Intangible assets with an indefinite useful life



Tutorial note

Easy marks are available for stating principles from IAS 38 Intangible Assets regarding the meaning of definite and indefinite, and how to account for assets which have an indefinite useful life.

IAS 38 Intangible Assets states that intangible assets have an indefinite useful life when there is no foreseeable limit to the period the asset is expected to generate net cash inflows for the entity. An intangible asset with an indefinite useful life is not be amortised.

IAS 36 *Impairment of Assets*, requires an entity to test an intangible asset with an indefinite useful life for impairment on an annual basis.

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

Locust and Clara

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



Tutorial note

Even without detailed knowledge of IAS 38 Intangible Assets, you should be able to reach reasonable conclusions using common sense.

The Locust perfume has been sold successfully in the market for many years and could be deemed to have an indefinite life.

The Clara perfume is linked to the popularity of the actor and therefore, it is difficult to assess whether the brand has an indefinite life as it is likely to be dependent upon the longevity of the popularity of the actor. In the case of the Clara perfume, it is difficult to state that the brand will have an indefinite life. Thus Clara is likely to have a finite life.

(iii) Proposed closure



Tutorial note

Easy marks are available for discussing the principles around non-current assets held for sale and discontinued operations.

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations states that an asset or disposal group should be classified as held for sale if its carrying amount will be recovered mainly through a sales transaction. It must be available for immediate sale in its current condition and the sale must be highly probable.

There is a formal plan for closure and an active search for a buyer so the sale is likely to qualify as highly probable. Once the liquidation sale is over the stores will be available to immediate sale – this is the point at which they should be classified as a disposal group held for sale.

IFRS 5 states that immediately before classifying a disposal group as held for sale, the carrying amounts of the assets and liabilities within the group are measured in accordance with the applicable IFRS Standards. After classification as held for sale, disposal groups are measured at the lower of carrying amount and fair value less costs to sell.

The six stores represent a component of Corbel Co because they are a separate geographical area of operations (Italy). As such, once classified as held for sale, they should be presented as a discontinued operation in the statement of profit or loss.

There may be a need to provide for the additional costs of closure such as redundancy costs, under IAS 37 *Provisions, Contingent liabilities and Contingent Assets*.

Suggested closure



Tutorial note

Without formal plans and formal announcements, the suggested closures are unlikely to fall within the scope of IFRS 5 Non-current Assets Held for Sale and Discontinued Operations or IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

Although there has been a local newspaper article that Corbel Co is to shut 30 stores with a loss of 500 jobs across the world over the next five years, there has been no formal announcement by Corbel Co. This means that a sale is not highly probable. As such, these stores would not qualify as held for sale and cannot be presented as discontinued operations. These stores should continue to be recognised and depreciated as normal.

Without formal plans, it is feasible that the closure of the additional 24 stores will not take place. This means that no obligation exists to restructure and, as per IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* no restructuring provision should be recognised.

(iv) Primary store



Tutorial note

State basic impairment principles for easy marks.

An entity needs to assess at the end of each reporting period whether there is any indication that an asset may be impaired. An indication of impairment is whether the performance of the asset is worse than expected.

The primary store is performing in line with expectations, so it would appear that there is no indication of impairment and no impairment test is required.



Tutorial note

The carrying amount of an asset should not exceed the benefits it will bring to the entity, whether directly or indirectly. Although the primary store makes a loss, this was expected and so were additional indirect benefits – this would all have been factored into the price Corbel paid. If a profit was expected, then Corbel might have paid more for the store, and thus the carrying amount would have been higher – in such circumstances an impairment review would have been needed.

If Corbel Co feels that the primary store benefits all the other stores from a brand perspective, there is an argument for treating the store as a corporate asset and allocating its carrying amount to the cash generating units when testing for impairment. However, it is likely that management assesses performance on a store-by-store basis – this adds weight to the argument that each store, including the primary store, is a separate cash generating unit because of their ability to generate cash flows independently from other company assets.

The amount of internet sales included when calculating value in use for the purposes of testing the primary store for impairment will depend on the quantity of sales that are sourced directly from it. Where Internet sales are sourced from a central warehouse or another store, the cash inflows should be excluded from the primary store's impairment assessment and included in the appropriate CGU.

		ACCA marking guide	
			Marks
(a)	Listir	ng of major challenges	
	1 ma	rk per point up to maximum	5
(b)	Discussion and application of the following to the scenario:		
	(i)	Treatment of brand on acquisition	2
		Allocation of brand to CGU	2
			4
	(ii)	Intangible assets with indefinite life principles	2
		Application to scenario	4
			6
	(iii)	NCA held for sale-principles	3
		Application to scenario	3
			6
	(iv)	Impairment principles	2
		Impairment of primary store	2
			4
T-4-!			35
Total			25

Examiner's comments

With regards to part (a), candidates are reminded that there will be other challenges outside of the suggested answer that would have scored marks. It is always a good idea to refer to the Conceptual Framework in answering such a question. For example, answers mentioning relevance, reliability, materiality, verifiability etc would have gained marks. The use of the Conceptual Framework is recommended in answering many questions even though it may not be specifically referred to in the question or the answer. Generally, in this type of question, candidates will score 1 mark for each well explained point.

With regards to part (b), if there is little reference to the scenario, there is a risk of missing key marks. Also, the scenario and requirements are linked – the requirement is based upon the scenario. It is very difficult to score good marks without using the scenario.

Only the relevant sections of the IFRS standard should be discussed. There is no point in setting out the terms of an IFRS standard if they are not relevant. In theory, a candidate could rote learn the whole of an IFRS standard and reproduce it in the exam, leaving the examiner to mark the relevant parts. This is a poor strategy as very few marks would be given if the examiner has to decide the relevancy of a rote learned answer

38



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



Key answer tips

This questions tests areas many students will be less familiar with – the SMEs Standard and the calculation of a service cost on an 'other long term benefit'. As such, you might find it tricky. However, part (a) in particular is less demanding than usual in terms of the level application skill required - but you do need to have the relevant knowledge. Question spotting in SBR (i.e. predicting what topics will be tested) is dangerous - study the whole syllabus!

(a) (i) Nature of the SME's Standard

The principal aim when developing the SMEs Standard was to provide a framework that generated relevant, reliable and useful information and the provision of a high quality and understandable accounting standard suitable for SMEs. The Standard itself is self-contained, and incorporates accounting principles based on full IFRS standards. It comprises a single standard divided into simplified sections for each relevant IFRS standard but which have also omitted certain IFRS standards such as earnings per share and segmental reporting. In addition, there are certain accounting treatments that are not allowable under the SMEs Standard. For example, there is no separate guidance for non-current assets held for sale.

To this end, the SMEs Standard makes numerous simplifications to the recognition, measurement and disclosure requirements in full IFRS standards. Examples of these simplifications are:

- Intangible assets must be amortised over their useful lives. If the useful life is not determinable then it is presumed to be 10 years.
- The cost model (investment is measured at cost less any accumulated impairment losses) can be used for investments in associates. This model may not be used for investments for which there is a published price quotation, in which case the fair value model must be applied.

The disclosure requirements in the SMEs Standard are also substantially reduced when compared with those in full IFRS standards partly because they are not considered appropriate for users' needs and for cost-benefit considerations.

(ii) Information asymmetry

IFRS for SMEs decreases information asymmetry between the firm and the users, because of its recognition, measurement and disclosure requirements. However, there are certain facts and information in companies which is not disclosed by them to investors under any accounting standards. SMEs have access to all relevant information, while investors lack much of the relevant information. Unfortunately, lack of relevant information will have an adverse effect on the decision-making of the investor. Information related to the SME's credit, project risk and benefits are known more by the SME than by the

investor giving the SME an information advantage. Therefore, investors are in a relatively disadvantaged position, and if they, for example, are financial institutions, they will raise lending rates to reduce potential risk of credit losses or may not invest at all. The more incomplete and the less transparent the information from the SME, the higher will be the risk related to the investment and the higher will be the return that the investor requires. The access to investment by SMEs could be determined by the quality of financial statements, information asymmetry and perceived risk. Quality financial statements reduce the level of information asymmetry which reduces perceived risk.

(iii) Integrated reporting

Integrated reporting could help SMEs better understand and better communicate how they create value. It can provide a roadmap for SMEs to consider the multiple capitals that make up its value creation. An integrated report represents a more complete corporate report which will help SMEs understand their business so they can implement a business model that will help them grow. SMEs use a range of resources and relationships to create value. An integrated reporting approach helps SMEs build a better understanding of the factors that determine its ability to create value over time. Integrated thinking helps SMEs gain a deeper understanding of the mechanics of their business. This will help them assess the strengths of their business model and spot any deficiencies. These will create a forward-looking approach and sound strategic decision making.

Some SMEs have few tangible assets and operate in a virtual world. As such, conventional accounting will fail to provide a complete picture as to its ability to create value. Capitals, such as employee expertise, customer loyalty, and intellectual property, will not be accounted for in the financial statements which are only one aspect of an SME's value creation. As a result, SME stakeholders can be left with insufficient information to make an informed decision.

Integrated reporting will include key financial information but that information is alongside significant non-financial measures and narrative information. Integrated reporting can help fulfil the communication needs of financial capital and other stakeholders and can optimize reporting.

(b) (i) Current service cost



Tutorial note

The benefit in the question is **not** a pension. Pensions are a type of postemployment income.

The benefit is paid to current employees but will not be settled within 12 months of the current reporting period. It is therefore an 'other long-term benefit'.

The accounting treatment for other long-term benefits is similar to defined benefit pension schemes, although remeasurement components are recognised in profit or loss. As such, Handfood is incorrect to recognise this in amount in other comprehensive income.

Handfood Co should recognise a liability for its obligations as a result of the additional employee benefit. The company will measure the benefit liability at the present value of its obligations at the reporting date. This amount is the estimated amount of benefit that employees have earned in return for their service in the current and prior periods.

Service costs, net interest and remeasurements should be recognised in profit or loss.

Handfood Co should recognise a current service cost expense of \$7,700 in profit or loss as set out below:

Expected final salary \$1.1million \times (1.03) ⁴	\$000 1,238
Benefit for the current year (1% \times \$1.238 million) Adjusted benefit for the current year (75% \times \$12,400)	12.4 9.3
Current service cost (($$9,300 \times 0.823$) discounted at 5% over 4 years)	7.7

This figure will be unwound each year and the movement recorded as the current service cost (in so far as no other changes to the assumptions are made).



Tutorial note

The above calculation is the model answer produced by ACCA. However, alternative methods would have been accepted.

Some candidates may have allocated the service cost over the five year service period, and recognised one fifth in each reporting period. ACCA have confirmed that this approach would have scored full marks.

Some candidates may have concluded that the obligating event occurred on 1 January 20X2 and that the service cost should be recognised at that date. The present value of this of this would be \$7,300. Interest on this amount is then recognised over the first year, equating to \$400. These two amounts total \$7,700, as per the calculation above. ACCA have confirmed that this approach would also have scored full marks.

(ii) An increase in employees' salaries above 3% per annum and a decrease in the probability of employees leaving the company would have the same effect on the additional benefit liability. The changes in the assumptions would both increase the benefit liability (discounted) at 31 December 20X3. This would in turn increase the current service cost for the year in profit or loss as the benefit payable on 1 January 20X7 will have increased as will the number of employees to whom the benefit will be payable.

Interest, which is calculated on the opening balance of the benefit obligation, will not be affected by the changes in assumptions. It will be charged to profit or loss at \$385 (\$7,700 \times 5%). Actuarial gains or losses arise when the assumptions change. In this case because, of the changes in assumptions, an actuarial loss will arise because of the increase in benefits payable and the obligation and this will be charged to profit or loss.

		ACCA marking guide	
			Marks
(a)	(i)	Discussion of IFRS for SMEs:	
		Simplifications and omissions	2
		Disclosure	1
		Recognised concepts	1
			4
	(ii)	Discussion of:	
	(11)	Information asymmetry issues and investors knowledge	4
		information asymmetry issues and investors knowledge	
	(iii)	Discussion of Integrated Reporting:	
	()	Better understanding	2
		Better communication	1
		Nature of IR	2
			5
(b)	(i)	Discussion of principles of accounting for additional benefit	4
(5)		liability/current service cost	7
		Calculation of current service cost 20X2	2
			6
	/···\		
	(ii)	Discussion of effect of change in assumptions	4
	Prof	fessional marks	2
	110	respondition to	
Total			25

Examiner's comments

It is understandable that in a time pressured exam, a candidate will resort to simply answering questions with rote knowledge. However, the SBR exam is looking for application of that knowledge and in this case, the context was SMEs. If a candidate simply described the 'capitals' in part (a) (iii) without any reference to SMEs, then the marks were reduced accordingly. Maximum marks will never be achieved if candidates do not apply their knowledge.

Part (a) of the question attracted professional marks. Candidates are not awarded these marks simply for answering the question, although this obviously helps and is another reason to ensure all questions, and parts of questions, are attempted. The marks were awarded for the quality of the discussion in part (a). This part contained requirements relating to investors and the investment decision. Therefore, if candidates did not discuss the 'investor perspective', then professional marks would not be awarded. These two marks can and often are the difference between pass and fail.

Part (b) (i) was not well answered, maybe because of time pressures or maybe because the principles were not understood. Candidates could still score a pass mark in this part of the question if they discussed the principles behind the calculation and candidates scored well when this was attempted.

Part (b) (ii) could have been answered without an attempt at part (b) (i), if the candidate had used basic principles.

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



Key answer tips

This question requires application of a range of core IFRS Standards. You should be able to score high marks on all parts if you have a good knowledge of the core principles in each. Remember to state the relevant rules from the standards for some easy marks.

(a) (i) Held for Sale



Tutorial note

Assessment of whether an asset qualifies to be categorised as 'held for sale' is a very common exam requirement. Make sure that you are aware of the qualifying criteria and can apply these to any scenario.

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations requires a non-current asset to be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through its continuing use. It must be available for immediate sale in its present condition, and its sale must be highly probable within 12 months of classification as held for sale. The standard only foresees an exemption to this rule if the sale is delayed by events or circumstances which are beyond the entity's control, which is unlikely to be the case in this instance. Leria Co has entered into a firm sales commitment but the sale will occur after the 12-month threshold. Therefore, the stadium cannot be classified as held for sale.

(ii) Barrier improvements

The \$2 million to be spent on crowd barrier improvements to the stadium should not be treated as a reduction of the asset's carrying amount at 31 October 20X5.

IAS 37 Provisions, Contingent Liabilities and Contingent Assets states that a provision can only be recognised where there is a present obligation (legal or constructive) as a result of a past event. There is no present obligation because Leria Co may decide not to carry out the improvements. Therefore the \$2 million should be added back to the carrying amount of the stadium and a corresponding credit made to profit or loss.



Tutorial note

You may not have approached this question through IAS 37. Instead, you might have discussed principles around offsetting – that is valid too.

Note: when provisions are recognised they should be presented as a liability on the statement of financial position. Liabilities and assets should not be offset (except under specific circumstances).

(iii) Sale and leaseback

A sale and leaseback transaction occurs where an entity transfers an asset to another entity and leases that asset back from the buyer/lessor.

The accounting treatment depends on whether a sale has occurred. Under IFRS 16 *Leases*, an entity must apply the IFRS 15 *Revenue from Contracts with Customers* requirements to determine when a performance obligation is satisfied.



Tutorial note

If it is concluded that the transfer of an asset is not a sale, then the seller/lessee will continue to recognise the underlying asset. The seller/lessee will recognised a financial liability equal to the proceeds received.

In this case it seems that a sale will occur on 30 November 20X6 because of the binding sale commitment.



Tutorial note

Clearly show all workings. The markers will be able to award you credit, even if you have made mistakes.

Leria Co should account for the sale and leaseback as follows:

- Derecognise the \$18.92 million (W1) underlying asset
- Recognise the \$30 million proceeds from the sale
- Recognise a right-of-use asset at \$16.4 million (W2)
- Recognise a lease liability at \$26 million
- Recognise a profit on disposal of the underlying asset of \$1.48 million (W3).

(W1) Carrying amount of the underlying asset

Carrying amount of stadium is \$20 million (\$18m + \$2m).

Depreciation for year to 31 October 20X6 is \$1 million (\$20m × 5%).

Depreciation for November 20X6 is \$0.08 million ((\$20m - \$1m) × 5% × 1/12).

The carrying amount at the sale date = \$20m - \$1m - \$0.08m = \$18.92m

(W2) Right-of-use asset

The right-of-use asset is recorded at the proportion of the asset's previous carrying amount that relates to the rights retained. This is $$16.4 \text{ million} (($26m/$30m) \times $18.92m)$.

(W3) Profit on disposal

The profit on disposal relates solely to the rights transferred. This amounts to \$1.48 million (\$30m + \$16.4m - \$18.92m - \$26m).

(b) (i) Intangible amortisation

IAS 38 Intangible Assets sets out a rebuttable presumption that amortisation based on revenue generated by an activity which includes the use of an intangible asset is not appropriate. This is because revenue is influenced by many factors that are not linked to the asset's economic consumption, such as inflation.



Tutorial note

You can still score well in the SBR exam without knowing every rule in each examinable standard. For example, many students will be unaware of the rebuttable presumption regarding revenue-based methods of amortisation but this does not matter. As long as you understand the underlying principles behind amortisation – matching the cost of an asset to the benefits it produces – then you are capable of producing a good answer to this question.

However, this presumption can be overcome when it can be demonstrated that revenue and the consumption of the economic benefits of the intangible asset are highly correlated. The intellectual property embodied in the television programmes will generate cash flows through the television channel subscriptions and the estimated revenues for a television programme determine the amount to be spent on producing the television programme. Therefore, in this case, revenue reflects a proxy for the pattern of consumption of the benefits received. Revenue and consumption of the economic benefits of the intangible asset seem highly correlated and therefore a revenue-based amortisation method seems appropriate.

The industry practice method is also acceptable and conceptually sound as it is based on an analysis of the remaining useful life of the programme and the recoverable amount. Such an approach does not contradict IAS 38's prohibition on revenue-based amortisation because it is not based on direct matching of revenue and amortisation.

The useful life of an asset is required to be reassessed in accordance with IFRS Standards at least at each financial year end. Where this results in a change in estimate, this is will be accounted for prospectively from the date of reassessment.

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

(ii) Player contracts

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



Tutorial note

The paragraph above is the model answer published by ACCA.

Please note that contingent consideration is not mentioned in either IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets. As such, the accounting treatment of contingent consideration payable on the acquisition of these assets is not clear-cut and alternative conclusions to ACCA's answer would be acceptable. For instance, you might have argued that changes in the contingent consideration believed to be payable would be recorded in the statement of profit or loss. Or you might have argued that the contingent costs would only be capitalised once the conditions had been satisfied. These approaches are acceptable. Whatever accounting policy is used, it must be applied consistently to all similar transactions.

The costs associated with the renegotiation of a playing contract should be added to the residual balance of the players' contract costs at the date of signing the contract extension. The revised carrying amount should be amortised over the remaining renegotiated contract length.



Tutorial note

An injury is an indication of impairment because the benefits received from the asset will be lower than expected. In other words, the entity is likely to have overpaid and so the carrying amount of the asset will be too high.

Where a player sustains a career threatening injury and is removed from the playing team, then the carrying amount of the individual would be assessed against the best estimate of the individual's fair value less any costs to sell and an impairment charge made in operating expenses reflecting any loss arising.



Tutorial note

A cash generating unit is the smallest group of assets that generate cash flows distinct from the rest of the business.

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

ACCA Marking scheme			
			Marks
(a)	(i)	Held for sale guidance	3
	(ii)	Accounting for barrier improvements	3
	(iii)	Sale and leaseback principles	4
		Accounting treatment	3
			13
(b)		Potential amortisation of the intangible asset	5
		Performance conditions and contract costs	5
		Value in use of a player/CGU	2
			12
Total			25

Examiner's comments

Part (a) (i) tended to be well-answered, provided candidates carefully reviewed the scenario to identify the contract commencing beyond the 12 month limit under IFRS 5 Noncurrent Assets Held for Sale and Discontinued Operations. Part (a) (ii) was consistently wellanswered: most candidates identified and justified a lack of obligating event and recommended the accounting correction required. However, some answers needlessly extended beyond the requirements by considered the treatment in the following reporting period, which was not asked for. The quality of answers to part (a) (iii) (the sale and leaseback) varied the most. Some answers omitted a relatively basic calculation of the carrying amount at disposal date, whilst others incorrectly took the present value of the lease obligations as the carrying value of the right of use asset. In both cases, this limited opportunities for marks. In part (b) (i), few answers considered the principles behind amortisation, and more specifically an application of those principles to this situation. Answers were often limited to a basic recommendation of amortising over the useful life of the asset, with little development or argument for alternative amortisation methods, other than suggesting use of a straight line approach if the consumption pattern is not reliably measurable. Answers to part (b) (ii) were relatively well-answered. Candidates generally justified why a footballer cannot be a CGU and the need for impairment testing of an injured player. Most identified the contract as an intangible asset. Fewer were confident regarding when and how to recognise the contingent payments.

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ECOMA (MARCH 2020) Walk in the footsteps of a top tutor



Key answer tips

Part (a) tests the topic of sustainability. This is part of the 'analysis' section of the syllabus, so two professional marks are available.

(a) Sustainability information



Tutorial note

Prior to the question being set, the examining team produced an article about sustainability reporting. It is important to read widely, and to regularly check the ACCA website for new articles.

There is increasing interest by investors in understanding how businesses are developing environmental, social or governance (ESG) goals. The positioning of the ESGs in relation to the overall corporate strategies is information which investors feel is very relevant to the investment decision which in turn will lead to capital being channelled to responsible businesses.

Sustainability practices will not all be equally relevant to all companies and investors' expectations are likely to focus on companies realising their core business activities with financial sustainability as a prerequisite for attracting investment. Because institutional investors have a fiduciary duty to act in the best interests of their beneficiaries, such institutions have to take into account sustainability practices. Companies utilising more sustainable business practices provide new investment opportunities. Investors realise that environmental events can create costs for their portfolio in the form of insurance premiums, taxes and the physical cost related with disasters. Social issues can lead to unrest and instability, which carries business risks which may reduce future cash flows and financial returns.

Investors screen the sustainable policies of companies and factor the information into their valuation models. Investors may select a company for investment based on specific policy criteria such as education and health. Investors may evaluate how successful a company has been in a particular area, for example, the reduction of educational inequality. This approach can help optimise financial returns and demonstrate their contribution to sustainability. Investors increasingly promote sustainable economies and markets to improve their long-term financial performance. However, the disclosure of information should be in line with widely-accepted recommendations such as the Global Reporting Initiative (GRI) and the UN Global Compact. Integrated reporting incorporates appropriate material sustainability information equally alongside financial information, thus providing reporting organisations with a broad perspective on risk.

Investors often require an understanding of how the directors feel about the relevance of sustainability to the overall corporate strategy, and this will include a discussion of any risks and opportunities identified and changes which have occurred in the business model as a result.

Investors employ screening strategies, which may involve eliminating companies which have a specific feature, for example, low pay rates or eliminating them on a ranking basis. The latter may be on the basis of companies which are contributing or not to sustainability. Investors will use related disclosures to identify risks and opportunities on which they wish to engage with companies. Investors will see potential business opportunities in those companies which address the risks to people and the environment and those companies which develop new beneficial products, services and investments which mitigate the business risks related to sustainability. Investors are increasingly seeking investment opportunities which can make a credible contribution to the realisation of the ESGs.

(b) (i) Roof



Tutorial note

State the criteria that must be satisfied for a provision to be recognised and then apply these to the scenario.

IAS 37 Provision, Contingent Liabilities and Contingent Assets requires a provision to be recognised if there is a present obligation from a past event, the settlement of which will result in the probable outflow of measurable economic resources. Ecoma Co cannot make a provision of \$16 million because it is under no obligation to replace its roof.

Head office



Tutorial note

In accordance with IFRS 16 Leases, a lessee must recognise a lease liability and a right-of-use asset for all leases except those that are short-term or low value.

The head office is a lease. In accordance with IFRS 16 *Leases*, Ecoma Co will have recognised a lease liability and a right-of-use asset in its statement of financial position.



Tutorial note

If assets are unused, idle or damaged then an impairment review should be performed.

Vacating the lease means that the right-of-use asset will provide no further economic benefits. This is an indicator of impairment and, in accordance with IAS 36 *Impairment of Assets*, an impairment review must be performed.

The carrying amount of the right-of-use asset must be compared with its recoverable amount. Recoverable amount is the higher of two figures: fair value less costs to sell, and value in use. If the lease cannot be sold or sublet, then the recoverable amount is likely to be nil. Any write down of the right-of-use asset to recoverable amount will be recorded as an expense in the statement of profit or loss.

(ii) Pension scheme



Tutorial note

The requirement asks you to 'advise' on the principles of accounting for the pension scheme. As such, most of the marks are for discussion of the correct accounting treatment.

At each financial year end, the plan assets and the defined benefit obligation are remeasured. The obligation is measured at present value, and the assets are measured at fair value.

The amount of pension expense to be recognised in profit or loss is comprised of the net interest component and service costs. Net interest is calculated by multiplying the opening net defined benefit liability by the discount rate at the start of the annual reporting period. Service costs are the current service costs, which is the increase in the present value of the defined benefit obligation resulting from employee services in the current period, and 'past-service costs'.

Ecoma Co's past-service costs are the changes in the present value of the defined benefit obligation for employee services in prior periods which have resulted from the plan amendment and should be recognised as an expense. IAS 19 *Employee Benefits* requires all past service costs to be recognised as an expense at the earlier of the following dates:

- (a) when the plan amendment or curtailment occurs, and
- (b) when the entity recognises related restructuring costs or termination benefits.

These costs should be recognised regardless of vesting requirements. Thus, the past service cost of \$9 million will be recognised at 30 September 20X5.

Remeasurement gains and losses are recognised in other comprehensive income.

The table below reflects the change in the net pension obligation for the period. The statement of profit or loss will be charged with the net interest component of \$3.2 million and the total service cost of \$27 million (\$18 million + \$9 million). Benefits paid have no effect on the net obligation as both plan assets and obligations are reduced by \$6 million. OCI will be credited with the \$1.2 million remeasurement gain. This gain cannot be reclassified to profit or loss.



Tutorial note

You need to set up a working like the one below in order to calculate the remeasurement component.

	\$m
Net pension obligation at 30 September 20X4	59.0
Net interest component (\$59m × 5.5%)	3.2
Current service cost	18.0
Past service cost	9.0
Contributions	(10.0)
Remeasurement (bal. fig.)	(1.2)
Net pension obligation at 30 September 20X5	24.0

(iii) Profit adjustments



Tutorial note

You are asked to 'calculate' the impact of the adjustments. No explanation or discussion is required.

\$m
25.0
(3.2)
(27.0)
(5.2)

		Marking scheme	
			Marks
(a)	Relev	/ance	2
	Oppo	ortunities	1
	Valua	ation models	2
	Risks		2
	Scree	ening strategies	1
			8
(b)	(i)	Provision	2
		Impairment	4
			6
	(ii)	Accounting for the pension scheme	4
		Calculations	3
			7
	(iii)	Calculation of impact on earnings	2
		Professional marks	2
Total			25

Examiner's comments

Part (a) was generally well-answered; with better answers suggesting that candidates are reading around this subject (including the SBR technical article on Sustainable Development Goals from the ACCA website). Very few candidates related disclosure with the Global Reporting Initiative (GRI) and the UN Global Compact.

Part b (ii) required an explanation with calculations of the principles of accounting for changes in the vesting period of a defined benefit pension scheme, including past service cost adjustments in the year. Answers to this part were often good, with some answers presenting clear net liability workings, and descriptions of the accounting requirements. However candidates often applied the incorrect discount rate to calculate net interest, and sometimes applied the incorrect signage (deducting service costs from the net obligation for example). Weaker attempts wasted valuable time describing the differences between defined contribution and defined benefit schemes which gained no marks as it was not a requirement

Part b(iii) asked for a calculation of the impact of the items in b(ii) on a given profit before tax. This was, surprisingly, often omitted with some errors in adding or subtracting adjustments or candidates may have run out of time. Time management is vital to ensure that all requirements of the question are met: in this case b (iii) was a relatively simple task following on from the answer to task b (ii).

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



Key answer tips

This is a big question. In SBR you have just under two minutes per mark, so there is simply not enough time to write a detailed answer like the one provided below. Students generally score better when they attempt all requirements, so aim to spread your time across each part of the question (rather than writing a very detailed answer to part (a) and then leaving parts (b) and (c) unanswered).

(a) (i) Revenue recognition: Clamusic Co shares



Tutorial note

Start with the relevant principle from the relevant accounting standard.

IFRS 15 Revenue from Contracts with Customers requires that non-cash consideration received should be measured at the fair value of the consideration received.



Tutorial note

An active market is one where there are regular sales of identical assets and liabilities. There is unlikely to be an active market for unlisted shares.

The fair valuation of shares in an unlisted start-up company is problematic. However, IFRS 13 Fair Value Measurement gives advice on how to measure unlisted shares. It sets out three approaches: (i) the market approach, such as the transaction price paid for identical or similar instruments of an investee; (ii) the income approach, for example, using discounted cash flows; and (iii) the adjusted net asset approach.



Tutorial note

The valuation provided in the following paragraph is just one possible answer. Alternative valuations score just as many marks as long as justification is provided.

In this case, the market approach has been used and the range of fair values is significant based upon the professional valuation report. The range of fair values for a 7% holding of shares would be \$280,000 to \$350,000 (7% of \$4–\$5 million) at the date of the contract and \$420,000 to \$490,000 (7% of \$6–\$7 million) at the year end. As the fair valuation is based upon a similar listed company and is based upon a controlling interest, a discount on the valuation of the shares should be applied to reflect the lack of liquidity and inability to participate in Digiwire Co's policy decisions. Thus an estimated value of the shares can be made which takes into account the above facts. This could be the mid-point of \$315,000 ((\$280,000 + \$350,000)/2) at the date of the contract and \$455,000 ((\$420,000 + \$490,000)/2) at the year end.



Tutorial note

Remember that revenue is recognised either over-time or at a point in time.

At contract inception the shares will be recognised at \$315,000. However, a corresponding entry should not be made to revenue. Digiwire Co retains an active role in the updating and maintenance of sold licence to ensure its continuing value to the client. As such, the customer is benefitting from Digiwire's continuing performance as Digiwire performs. In accordance with IFRS 15 Revenue from Contracts from Customers, revenue should be recognised over time – most likely over the three year contract term. Any difference between the initial carrying amount of the shares and the revenue recognised is recorded as a contract liability.

Clamusic Co share valuation at 31 December 20X6



Tutorial note

An investment in the equity instruments of another entity is a financial asset (unless the investor has control, joint control, or significant influence over the investee).

Equity investments in scope of IFRS 9 Financial Instruments should be measured at fair value in the statement of financial position, with gains and losses on remeasurement recognised in profit or loss. If an equity investment is not held for trading, an entity can make an irrevocable election at initial recognition to measure it at fair value through other comprehensive income (FVTOCI) with only dividend income recognised in profit or loss.

The shares will be remeasured to \$455,000 ((\$420,000 + \$490,000)/2) at 31 December 20X6. A gain of \$140,000 (\$455,000 - \$315,000) will be recorded in profit or loss or other comprehensive income dependent upon any election being made. If Digiwire Co elects to present the remeasurements through other comprehensive income, the gain will never be reclassified to the statement of profit or loss.

(ii) Revenue: royalties

IFRS 15 states that revenue from a sales-based royalty should be recognised when the subsequent sale occurs.

At the end of the first year of the contract, revenue from royalties can be calculated based upon the sales for the period. This would be $$50,000 (5\% \times $1 \text{ million})$.

The Conceptual Framework support



Tutorial note

The question is quite vague about what areas of the Conceptual Framework should be discussed. Alternative answers, such as discussions of the definitions of the elements, would therefore be awarded marks.

The *Conceptual Framework* states that an item which meets the definition of an element should be recognised if recognition provides useful financial information. In other words:

- (a) relevant information; and
- (b) a faithful representation of the underlying transaction.



Tutorial note

Do not just recite key principles from the Conceptual Framework. Make sure that you apply these principles to the accounting treatment of the sales-based royalty.

Recognition of royalties earned during the year in the statement of profit or loss will help users of the financial statements to assess Digiwire Co's economic performance and thus make investment decisions. The sales made in the year can be accurately measured and so the royalty can be accurately calculated – thus a faithful representation of the income earned in the period is possible.

Future royalty incomes, relating to years two or three of the contract, should not be recognised because Digiwire has not yet performed in those economic periods. Moreover, future royalties cannot be measured with any certainty and so estimation and recognition of these would not provide a faithful representation of revenue earned in the period. The principles in the *Conceptual Framework* relating to recognition are therefore consistent with the approach taken by Digiwire Co.

(b) (i) FourDee Co



Tutorial note

Make sure that you know the definition of joint control because this principle is regularly tested in SBR.

IFRS 11 *Joint Arrangements* defines joint control as the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. This would seem to be the case with FourDee Co because decisions are made by a unanimous vote of the two parties that share control.



Tutorial note

There are two types of joint arrangements: joint ventures and joint operations. Joint ventures are usually a separate company.

The investment in FourDee Co would seem to qualify as a joint venture. This is because FourDee Co is a separate company so the venturers have rights to the net assets of the arrangement



Tutorial note

The accounting treatment of a joint venture is the same as the accounting treatment of an associate.

A joint venturer accounts for an investment in a joint venture using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures*. This means that the investment is initially recognised at cost. The venturer will subsequently recognise its share of the joint venture's profits and other comprehensive income.

(ii) Derecognition of assets



Tutorial note

According to the Conceptual Framework, assets are derecognised when the entity no longer has control. Liabilities are derecognised when there is no longer a present obligation to transfer an economic resource.

Digiwire Co has exchanged non-monetary assets for its investment in FourDee Co, and thus needs to de-recognise the assets it is contributing to FourDee Co. The carrying amount of \$6 million of the property is derecognised but the intellectual property of Digiwire Co has been generated internally and does not have a carrying amount. The cryptocurrency is recorded as an asset in the financial statements of Digiwire Co at \$3 million and must also be derecognised.

Profit on disposal

When a joint venturer contributes a non-monetary asset to a joint venture in exchange for an equity interest in the joint venture, the joint venturer recognises a portion of the gain or loss on disposal which is attributable to the other parties to the joint venture (except when the contribution lacks commercial substance). As such, Digiwire Co is required by IAS 28 to limit the profit on disposal of its non-monetary assets to 50% because, effectively, Digiwire has only disposed of 50% of the assets contributed to the joint venture.

Thus the carrying amount of the joint venture in Digwire's financial statements at 31 December 20X6 will be \$11.5 million ((\$6m + \$3m carrying amounts\$ derecognised for property and cryptocurrency) + ((<math>\$4m - \$3m)/2) + ((\$10m - \$6m)/2)). A gain of \$2.5 million will be recorded in profit or loss.

(iii) Cryptocurrency



Tutorial note

Some companies accept cryptocurrency as a form of payment. However, as yet, cryptocurrency is not widely accepted.

Cryptocurrency is not cash or cash equivalents as its value is exposed to significant changes in market value and there is no contractual right to receive either cash or cash equivalents. Therefore, cryptocurrency does not meet the definition of a financial asset per IAS 32 *Financial Instruments: Presentation*.

IAS 38 *Intangible Assets* defines an intangible asset as an identifiable non-monetary asset without physical substance. Cryptocurrency would seem to meet this definition.

If the cryptocurrency is to be recognised as an intangible asset then it could be measured at cost less amortisation and impairment. If the useful life was determined to be indefinite then no amortisation would be charged. Because there is an active market for the cryptocurrency, it would be possible for it to be measured at fair value instead. If measured at fair value then any gains on remeasurement would be presented in other comprehensive income and the gain would not be reclassified through profit or loss when the cryptocurrency is derecognised.



Tutorial note

Remember that the Conceptual Framework provides useful guidance to preparers of financial statements when an IFRS Standard offers a choice of accounting policy or when no IFRS Standard exists for a particular transaction.

When offered a choice of measurement base, the *Conceptual Framework* states that consideration should be given to the characteristics of the asset and the way in which it contributes to future cash flows. Cryptocurrency has a volatile market value and is often traded in the short-term. As such a current value measurement (such as fair value) is likely to provide more relevant information that historical cost.

The Conceptual Framework states that profit or loss is the primary source of information about economic performance during the reporting period and that income and expenses would normally be presented in this statement. Income or expenses might be presented in other comprehensive income if they result from a current value remeasurement and if presentation in other comprehensive income increases the relevance of profit or loss. However, if cryptocurrency is held as an investment, then economic returns earned in the period are likely to be of interest to investors when assessing overall economic performance. Therefore, gains and losses on remeasurement of cryptocurrency to fair value should probably be recorded in profit or loss. This treatment would be consistent with financial assets held in the short-term, measured in accordance with IFRS 9 Financial Instruments.

(c) IAS 19 Employee Benefits



Tutorial note

Basic points will still score you a mark if relevant to the question.

According to IAS 19 *Employee* Benefits, any gain or loss arising on a curtailment is recognised in the statement of profit or loss.



Tutorial note

State the accounting principles regarding a mid-year plan amendment, curtailment or settlement.

When a plan amendment, curtailment or settlement occurs during the annual reporting period, an entity must:

- Determine current service cost for the remainder of the period after the plan amendment, curtailment or settlement using the actuarial assumptions used to remeasure the net defined benefit liability/asset reflecting the benefits offered under the plan and the plan assets after that event.
- Determine net interest for the remainder of the period after the plan amendment, curtailment or settlement using: (i) the net defined benefit liability/asset reflecting the benefits offered under the plan and the plan assets after that event; and (ii) the discount rate used to remeasure that net defined benefit liability/asset.



Tutorial note

Show your workings.

The current service cost would be \$96 million ((8 months \times \$9 million) + (4 months \times \$6 million)).

The net interest component would be calculated as $$1,020,000 (($900,000 \times 8/12) + (3.5\% \times $36m \times 4/12))$.

		Marking guide	
(a)	(i)	application of the following discussion to the scenario: IERS 15 non-cash consideration and IERS 13 alternatives to	Marks
		value the shares (including share value calculation at year end)	3
	(ii)	IFRS 9 remeasurement gains (including calculation)application of the following discussion to the scenario:	3
		revenue recognised over time	2
		Conceptual Framework	2
			10
(b)	(i)	 discussion and application of the IFRS 11 requirements to the scenario 	3
	(ii)	 discussion of the derecognition of non-monetary assets and application to the scenario 	2
		 calculation of carrying amount of the joint venture 	1
	(iii)	 discussion of the potential ways in which the cryptocurrency could be accounted for at fair value 	4
			10
(c)	Curta	ailment in P/L	1
		iples relating to curtailment and impact on service/interest	2
	Calcu	ılations	2
			5
Total			25

Examiner's comments

Part (c) was the least well-answered, with many candidates choosing to avoid answering altogether. Candidates who were unaware of the amendments should at least have been in a position to critically describe the previous method by which each cost was calculated. Appropriate discussion would have been awarded marks. Part (a) required a valuation of the equity investment, and was generally well-answered. The royalties aspect also required a demonstration of how the *Conceptual Framework for Financial Reporting* supported the suggested treatment. Answers tended to focus on the more general aspects of the *Conceptual Framework*, whilst the answer called for those aspects relating to the scenario, such as recognition requirements. In part (b) very few recognised that the disposal was effectively 50% of the assets contributed (relating to the part attributable to the other party of the joint venture). The final requirement of part (b) tested whether cryptocurrency can be classified as a financial asset or intangible asset, and whether valuation movements should appear in profit or loss. Answers to this were generally weak; and again, some answers ignored this requirement altogether. This is surprising given that there is a technical article on cryptocurrency.

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



Key answer tips

Lots of easy marks are available in part (b) and long as you are answering all of the requirements. If you forget to calculate ratios, or neglect to talk about the impact of the transactions on ROE, then you throw away easy marks. Two professional marks are available in part (b) – try and keep you answer as clear and understandable as possible.

(a) Accounting policy choices

If an IFRS Standard allows an entity an accounting choice, the financial statements will be affected by that choice.

The accounting policy chosen might be driven by self-interest. Companies may use the financial choices to increase earnings, and manipulate accounting figures in order to influence contractual outcomes which depend on the accounting figures reported.



Tutorial note

The question does not explicitly refer to the Conceptual Framework. However, the Conceptual Framework provides guidance for preparers of financial statements when an IFRS Standard offers a choice of accounting policy – and so the principles that it outlines are relevant here.

Accounting choices exist to provide companies which operate under different business models with the option of utilising an accounting method which best represents their operations. When an accounting standard offers a choice of accounting policy, the Conceptual Framework states that the information provided must be useful – i.e. relevant and a faithful representation of the entity's underlying transactions. A faithful representation means that, to the maximum extent possible, the financial statements are complete, neutral and free from error. A faithful representation is affected by the level of measurement uncertainty in the financial statements.

Comparability is one of the four qualitative characteristics which enhances the usefulness of financial information.



Tutorial note

The other enhancing qualitative characteristics of useful financial information are timeliness, understandability and verifiability.

Accounting information is more useful if it can be compared with similar information from other companies, or from the same company. Where there is flexibility when applying an IFRS Standard, financial statements can become less comparable with other companies. However, if guidance in the *Conceptual Framework* is followed, companies with the same business models or that hold assets or liabilities for similar purposes are likely to measure them in similar, comparable, ways.

Comparability is crucial to improve financial reporting quality but it can be argued that comparability is made more difficult by the fact that the Board allows entities to choose between alternative measurement bases. Environmental, economic, political, cultural, operational differences could be solved with the existence of accounting choices in the standards, but these choices could be at the cost of comparability.

(b) (i) Usefulness of return on equity

The return on equity (ROE) ratio measures the rate of return which the owners of issued shares of a company receive on their shareholdings in terms of profitability. This metric is especially important from an investor's perspective, as it can be used to judge how efficiently the firm will be able to use shareholder's investment to generate additional revenues.

The net profit margin (net profit/sales) tells how much profit a company makes on every dollar of sales.

Asset turnover (sales/assets) ratio measures the value of a company's sales or revenues generated relative to the carrying amount of its assets. The asset turnover ratio can often be used as an indicator of the efficiency with which a company is deploying its assets in generating revenue.

The equity ratio (assets/equity) indicates the relative proportion of the company's assets that are financed by equity. The equity ratio is a good indicator of the level of leverage used by a company by measuring the proportion of the total assets which are financed by shareholders, as opposed to creditors.



Tutorial note

Calculating the ratios is an easy source of marks.

	20X5	20X6
Net profit margin	15%	17.3%
Asset turnover	0.8	1.05
Equity ratio	1.43	2.1
Return on equity	17%	38%



Tutorial note

The return on equity formula provided in the question can be simplified.

Return on equity = net profit/equity

(ii) Setting up of special purpose entity (SPE)



Tutorial note

Remember to comment on the impact on ROE and its constituent elements.

By transferring their assets to a SPE, the asset turnover ratio will be significantly larger making the entity look more efficient. Furthermore, the revaluation reserve has been charged, thus reducing equity, and improving the ROE ratio.



Tutorial note

Use your knowledge from IFRS 10 Consolidated Financial Statements to explain why the treatment of the SPE is incorrect.

IFRS 10 Consolidated Financial Statements states that an investor controls a SPE when it is exposed, or has rights, to variable returns from its involvement with the SPE and has the ability to affect those returns through its power over the SPE. Power is the current ability to direct the activities which significantly influence returns. As such, the SPE should be consolidated by Guidance Co in its group financial statements. The property should be included in the group's assets and the charge eliminated from the revaluation reserves. The adjustment will increase shareholder equity, thus reducing ROE.

Miscellaneous transactions - share buyback



Tutorial note

The accounting entry for a share buyback is:

Dr Equity X

Cr Cash X

A major concern about using ROE is when a company buys back its shares. This decreases the equity on the statement of financial position. As the equity portion of ROE shrinks, the ROE metric gets larger. The ROE calculation can become meaningless if a company regularly buys back its shares. As a result there may be better metrics for investors to use (such as the P/E ratio).

Miscellaneous transactions - associate



Tutorial note

The investment in the associate is likely to affect year-on-year comparability. Stripping out the impact of the investment may provide more relevant trend analysis of performance.

Guidance Co has included \$4m profit ($$32m \times 6/12 \times 25\%$) from an associate in the current year's figures. The associate was purchased in the current year. If the share of the results of the associate were excluded, this would allow Guidance Co's profitability to result exclusively from Guidance Co's asset base. It could be argued that the full value of the company's reported profit including the associate could distort the analysis of Guidance Co's performance as compared to the last financial year.

There is no need to adjust for the original \$15 million investment in the associate because one asset is merely being replaced by another but total assets, and total equity, remain the same.

Adjusted amounts



Tutorial note

The examiner commented that better quality answers used a table to show the adjustments needed to the 20X6 figures. Label the table. This provides an audit trail for the marker, making it easier for them to give you credit if you make a mistake.

		SPE property	Shares cancelled	Associate	Total
		\$m	\$m	\$m	\$m
Net profit before tax	38			(4)	34
Sales	220				220
Assets	210	50	30		290
Equity	100	50	30	(4)	176

Adjusted calculations

	20X5	20X6	20X6
		(adjusted)	(unadjusted)
Net profit margin	15%	15.5%	17.3%
Asset turnover	0.8	0.76	1.05
Equity ratio	1.43	1.65	2.1
ROE	17%	19.3%	38%



Tutorial note

The investor's share of the associate's profit is recognisd in profit or loss and also increases the carrying amount of the investment in the associate. As such, in the adjustments table above, some candidates may also have removed \$4 million from the entity's assets. This adjustment was not made by the examining team but would have been acceptable and scored marks.

It can be seen that if the impact of the transactions in the period were eliminated, then ROE, and its component parts, significantly reduce. The buyback of shares and the purchase of the associate were legitimate transactions but they have been eliminated in order to determine comparative metrics. The accounting treatment of the SPE was contrary to IFRS 10 and would have been reversed in any event. Although financial metrics are intended to enable comparisons between companies, the relative performance of any particular company can be affected by transactions both acceptable and unacceptable under accounting standards.

		ACCA marking guide	
			Marks
(a)	_	discussion of the issues relating to accounting choice	3
	-	discussion of whether faithful representation and comparability are affected	3
			6
		the state of the s	
(b)	(i)	 discussion of the meaning of the return on equity (ROE) and its component parts 	3
		 calculation of ROE for the years ended 31 December 20X5 and 20X6 	2
			5
	(ii)	 application of the following discussion to the scenario: 	
		transfer of property to SPE	3
		buy back of shares	3
		purchase of associate	2
		calculation of the impact on ROE and its component parts	4
			12
	Prof	essional marks	2
Total			25

Examiner's comments

Answers to part (a) were generally well-presented, with a good description of the need to reflect the characteristics of assets and liabilities, although at a potential cost to comparability (an enhancing qualitative characteristic). Fewer answers considered the need to best represent the business model of the entity. Part (bi) was also well-answered in general, although surprisingly few candidates provided a clear description of the component elements of ROE, despite the requirement clearly asking for it. In part (b) (ii), most candidates identified the impact that the transactions had on the comparability of the current year's ROE. Better answers provided a table in which the original accounting data is adjusted for each transaction. A methodical approach yielded good marks; whilst weaker answers presented unclear workings without any referencing or commentary. Overall, this question was well-answered.

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



Key answer tips

Part (a) (i) tests a very popular exam topic – the definitions of 'control' and 'joint control'. This should be a source of easy marks. In contrast, part (a) (ii) tests a much more difficult part of the syllabus - embedded derivatives. That said, easy marks are available here for basic knowledge, such as the fact that derivatives are measured at fair value through profit or loss.

Part (b) is about the impact on investor analysis when an entity applies IFRS 16 Leases. Two professional marks are available here if your answer is well organised and addresses the question. Make sure that you distinguish between parts (i) and (ii) - discussion of ratios should be kept to the latter part.

(a) (i) Joint control

Before assessing whether an entity has joint control over an arrangement, an entity must first assess whether the parties control the arrangement in accordance with the definition of control in IFRS 10 Consolidated Financial Statements. If not, an entity must determine whether it has joint control of the arrangement.



Tutorial note

Control is normally presumed if the investor owns more than 50% of the investee's ordinary shares. However, it is possible to own less than 50% of the ordinary shares and still have control – for instance, if the other shareholdings are dispersed, or if the investor is able to control the decisions made at a board level.

IFRS 10 states that control requires power over the investee which gives the investor the ability to direct the relevant activities. Crypto does not have the ability to direct the relevant activities as it can only block decisions, and cannot make decisions by itself. Also, there is no shareholder agreement which sets out shareholders' voting rights and obligations and thus the other shareholders can act together to prevent Crypto from making decisions in its own interest. As such Crypto does not have control over Kurran.



Tutorial note

Start off with the definition of joint control and there try and apply this to the scenario.

IFRS 11 Joint Arrangements defines joint control as 'the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control'. It must be clear which combination of parties is required to agree unanimously to decisions about the relevant activities of the arrangement. In the case of Kurran, there is more than one combination of parties possible to reach the required majority. As a result, Crypto does not have joint control.



Tutorial note

The requirement asks you to 'advise the directors of Crypto as to how the above issues should be accounted for.' Make sure you finish your answer by explaining the correct treatment of the investment in Kurran.

IAS 28 Investments in Associates and Joint Ventures states that an associate is an entity over which the investor has significant influence. Significant influence is presumed when the investor owns between 20% and 50% of the ordinary shares. Therefore, it appears that Kurran is an associate of Crypto and should be accounted for in the consolidated financial statements using the equity method.

(ii) Embedded derivative

The contract is a hybrid contract. It contains a host contract, which is an executory contract to purchase electricity at a price of 20 million euros. The contract also contains an embedded derivative to sell dollars in the future to buy 20 million euros.

The host contract is not a financial asset. As such the embedded derivative is only separated out if the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract. This would seem to be the case, because neither party to the contract has a functional currency of Euros. As such, it is acceptable to separate the embedded derivative but it should have been measured at fair value through profit or loss, rather than at fair value through other comprehensive income.



Tutorial note

Remember that derivatives are always measured at fair value through profit or loss unless hedge accounting is applied.

Note that it is not mandatory to separate the embedded derivative. Instead the entire hybrid contract can be measured at fair value through profit or loss.

At the date of the modification of the contract, there is a significant change to the contract. The contract no longer contains an embedded derivative and is instead an executory contract (outside the scope of IFRS 9). The embedded derivative component that has been accounted for separately must therefore be derecognised.



Tutorial note

According to the Conceptual Framework, an executory contract is one where neither party has performed any of its obligations (e.g. a purchase contract where the purchaser has not paid and the seller has not started to satisfy the performance obligations in the contract). The contract will be unrecognised until an entity starts to perform - i.e. Crypto will record electricity at the cost of purchase when received from the supplier.

(b) (i) Key changes to lessee accounting



Tutorial note

In previous versions of the lease standard, certain types of lease would require that the lessee did not recognise an asset or a liability. In contrast IFRS 16 Leases requires that a right-of-use asset and a lease liability is recognised for almost all leases. Try and draw out the impact of this on both the statement of financial position and the statement of profit or loss. Why was this change useful for investors, and what impact might it have on their analysis of financial position and financial performance?

Even without knowledge of the rules from the previous version of the lease standard, the preamble to the question gives enough information regarding the prior treatment of lease liabilities (or, more accurately, the non-treatment) to enable candidates to answer the question. Use the content of these introductory paragraphs to generate ideas, as they can contain useful hints towards the direction of travel of an expected answer.

IFRS 16 Leases introduces a single lessee accounting model. Upon lease commencement, a lessee recognises a right-of-use asset and a lease liability unless the lease is short-term or of minimal value. The lease liability is initially measured at the present value of the lease payments still to be paid over the lease term, discounted at the rate implicit in the lease. The right-of-use asset is recognised at the same amount, plus any payments made at or before commencement of the lease, plus any initial direct costs.

Investors should bear in mind that some sectors and some companies will be more affected than others. As a result of applying IFRS 16, companies with previous material off-balance sheet leases will report higher assets and liabilities.

IFRS 16 results in more information about leases both on the statement of financial position and in the notes. Investors will no longer have to estimate the assets and liabilities resulting from off-balance sheet leases when calculating financial statement ratios. The standard should therefore make it easier to compare companies that lease assets with those that borrow to buy assets.

IFRS 16 requires a lessee to disclose lease liabilities separately from other liabilities as a separate line item, or together with other similar liabilities, in a manner which is relevant to understanding the lessee's financial position. A lessee will also split lease liabilities into current and non-current portions, based on the timing of payments.

After lease commencement, a lessee measures the right-of-use asset using a cost model less accumulated depreciation (and accumulated impairment if applicable). The lease liability is increased by interest, and reduced by the repayments made. The impact on the statement of profit or loss is a depreciation expense on the right-of-use assert (normally presented as an operating expense) and an interest expense on the lease liability (normally presented as a finance cost). In contrast, entities that previously had off-balance sheet leases would most likely have presented the full lease expense as an operating expense. Applying IFRS 16 is therefore likely to lead to an increase in profits before interest and tax (profits from operations).

(ii) Accounting ratios

The recognition of an asset which was previously unrecognised will result in a higher asset base, which will affect ratios such as asset turnover. The recognition of a liability which was previously unrecognised will result in higher liabilities, which will affect gearing. The recognition of depreciation and interest instead of operating lease expenses will result in higher operating profit because interest is typically excluded from operating expenses and will affect performance ratios. Similarly, profit measures which exclude interest and depreciation but previously included operating lease expense, such as EBITDA, will be higher under IFRS 16.



Tutorial note

Try and think about the impact of IFRS 16 on the constituent parts of each ratio. For example, IFRS 16 will lead to an increase in earnings before interest and tax, but also an increase in the interest expense.

If you are struggling here then make up some numbers so that you can see the impact more clearly.

Interest cover: accounting for leases in accordance with IFRS 16 will increase earnings before interest and tax (EBIT), because the interest expense on the lease liability will most likely be presented as interest. This change in EBIT will not be proportionate to the overall change in interest so the ratio will be change. The actual change in the ratio, however, will depend on the characteristics of the lease portfolio. This is because the interest charge on the lease liability is higher in the earlier years of a lease.

Return on capital employed: it is likely that ROCE will be lower under IFRS 16 because the increase in earnings before interest and tax is unlikely to be proportionate to the increase in capital employed.

Debt to EBITDA: the amount of debt will rise because lease liabilities will be recognised on the statement of financial position. EBITDA will rise because, under IFRS 16, the whole lease expense comprises either depreciation of the right of use asset or interest on the lease liability. The ratio of debt to EBITDA will increase because the increase in debt will be greater than the increase in EBITDA.

ACCA marking guide				
		Marks		
(a)	 (i) – discussion of the following accounting issues and application to the scenario: 			
	the definition of control per IFRS 10 and joint control per IFRS 11 power over the investee	3		
	Maximum	6		
	(ii) – discussion of the following accounting issues and application to the scenario:			
	IFRS 9 requirements for embedded derivatives and hybrid IFRS 9 requirements for contract modifications	3 2		
	Maximum	5		
(b)	(i) –a discussion of the IFRS 16 requirements –implications for investors	3		
	Maximum	6		
	(ii) -a description of the IFRS 16 impact on accounting numbers -impact on the following ratios:	2		
	Interest cover	2		
	ROCE Debt to EBITDA	1 1		
	Maximum	6		
	Professional marks	2		
Total		25		

Examiner's comments

Answers to the first part of the question were relatively weak. The scenario explained that the company held half of the board's nominations and that the directors sought advice over the applicability of IFRS 11. Most answers focused on this standard, but better answers began by considering the aspect of control: first, whether control was exhibited in accordance with IFRS 10 (individual control), then if joint control existed (IFRS 11), before finally considering the treatment without control, but with significant influence (IAS 28).

The second part was not well-answered, with a significant minority of candidates failing to answer this part at all or providing a very limited answer.

Many candidates explained the key changes on the application of IFRS 16; although the explanation was in some cases limited to a description of the accounting adjustments (the introduction of a right of use asset and corresponding liability) with limited consideration of the investor's viewpoint. Better answers described how certain industries would be more significantly affected, outlined the benefits to the investor of the change (increased comparability, no need to estimate off-balance sheet liabilities), and how disclosures should aid understanding. Answers to the last part of the question were generally good, provided the impact on each stated ratio was linked to the change in accounting treatment.

44 ZEDTECH (MAR/JUN 2019)



Key answer tips

Parts (a) tests principles relating to revenue recognition. It involves very few numbers, and so tests this topic very differently than questions in lower level exams.

Part (b) examines a current issue relating to sustainability reporting and developments but applies it practically to the Zedtech business.

Part (c) covers a technical area that has been added to the syllabus for 2022/23, being deferred tax and leases. Make sure you study this section as new areas tend be a favourite of the examiner.

(a) (i) Principles from IFRS 15 Revenue from Contracts with Customers

IFRS 15 Revenue from Contracts with Customers states that an entity must first identify the contract with the customer. As part of this, the entity must determine whether it is probable that the consideration which the entity is entitled to in exchange for the goods or services will be collected.

Once an entity has identified the contract with a customer, it evaluates the contractual terms and its customary business practices to identify all the promised goods or services within the contract. It must then determine which of those promised goods or services will be treated as separate performance obligations. A good or service is distinct if the customer can benefit from the good or service on its own, or together with the resources readily available to it.

(ii) Oinventory

As regards 0inventory, it seems that all of the individual goods and services in the contract are distinct because the entity regularly sells each element of the contract separately and is not providing the significant service of integrating the goods and services. Also, as the customer could purchase each good and service without significantly affecting the other goods and services purchased, there is no dependence upon individual elements of the service. Thus hardware, professional services and hosting services should each be accounted for as separate performance obligations.

InventoryX

Regarding InventoryX, the professional services are distinct because Zedtech frequently sells those services on a stand-alone basis. These should be dealt with as a separate performance obligation.

The hardware is integral to the delivery of the hosted software and cannot be used on its own. This means that the provision of the hardware and hosting services together form a single performance obligation.

Collectability

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

(b) Factors affecting sustainability reporting of Zedtech

Sustainability has become an increasingly crucial aspect of running a business and, as a consequence, the reporting of sustainability is a hot accounting topic. The UN has produced 17 Sustainability Development Goals (SDGs) and buy in from industry has a part to play in achieving these goals. There is also a growing recognition that sustainability can have a significant effect on a company's financial performance. Entities are more likely to volunteer to disclose the methods and processes that will help to achieve these SDGs through increased sustainability reporting. Therefore, the directors of Zedtech should consider how their operational practices may impact sustainability.

The nature of Zedtech's business creates a variety of factors that the directors should consider which may affect sustainability. Zedtech, as a software development company, operates in a high-tech industry. It provides data-hosting services and online inventory management services. It can be assumed that Zedtech operates using large server networks, possibly utilising cloud storage. This assumption can be ratified through the lease agreement for servers entered into by Zedtech. Online storage of data utilises vast amounts of energy through the powering and maintenance of the servers required. CO_2 emissions are a significant concern. For Zedtech to be considered a sustainable business, it should be actively investigating ways that could reduce Zedtech's carbon footprint e.g. utilisation of renewable energy, strategies of server temperature reduction.

Zedtech has recently started to provide services in a new geographic location. This could create different or unforeseen sustainability risks for Zedtech. Proper research should have been undertaken before entering the market place to ensure operational practices within the region do not expose Zedtech to negative press. For example, if the region has less rigorous labour laws in place, has a reputation for promoting inequality within the work place, operates under poor working conditions or has a negative reputation regarding environmental concerns. The actions performed by Zedtech to ensure the new region operates in a sustainable fashion should form part of any sustainability reporting.

The same considerations applied to the region as a whole, could also be applied to the customers and, if necessary, the suppliers (say if local servers were required to facilitate the contracts) with which Zedtech undertakes business in the new regions. Zedtech cannot declare to be at the forefront of sustainable business if the entities with which they trade do not share the same approach. If that were the case, Zedtech's reputation will be tarnished through association.

The new regions of operation could create the need for more travel and for exporting hardware overseas. This would lead to an increase in Zedtech's carbon footprint.

The Oinventory and InventoryX packages provide hardware to Zedtech's customers. Consideration of the impact to the environment of the production and disposal of the Zedtech hardware would be an important sustainability factor that should be demonstrable. Zedtech would want to promote any use of recycled raw materials and the production of recyclable and biodegradable finished goods.

The main stakeholders in companies (shareholders, financiers, investors, employees, customers, suppliers, governments, and the public) are increasingly integrating consideration of sustainability issues into their decision-making. Stakeholders require a greater understanding of the wider social and environmental context in which the business operates. Creating a positive picture through the adoption of sustainability practices and their subsequent disclosure invokes greater trust and credibility with stakeholders.

In their eagerness to present an image of promoting sustainability, the directors of Zedtech must be wary of overstating their engagement in sustainable practices. If decisions by stakeholders are influenced by proclamations included within the sustainability report, which subsequently are proven to have no substance, the resulting backlash could tarnish the reputation of Zedtech, perhaps to greater levels than if Zedtech ignored sustainability issues altogether. Zedtech could find itself subject to swathes of negative press, customer and investor boycotts and even protests at company locations.

As Zedtech is a listed entity, investors, whether current or potential, are clearly an important stakeholder. In recent times, investor groups have shown an appetite for products which recognise and reflect the relationship between their investments and social and environmental conduct. Investors need to completely understand the nature of the companies in which they are looking to invest and like to incorporate sustainability factors into investment decisions.

Analysis of the impact Zedtech has on sustainability could be the deciding factor for potential investors. If the company is viewed poorly based on its sustainability performance, it could lead to a potential investor investing their money elsewhere.

(c) Deferred tax and leases

In accordance with IFRS 16 *Leases*, a lease liability is recognised for \$15 million, being the present value of future lease payments. The right-of-use asset is recorded at \$19m, being the lease liability plus payments already made (\$15m + \$4m).

However, the initial advanced payment needs to be considered for deferred tax purposes separately from the recognition of the lease liability and right-of-use asset.

Considering the deferred tax created by the initial recognition of the lease liability firstly, the tax relief granted in this jurisdiction relates to the lease liability of \$15m rather than the right-of-use asset. This causes the tax base of the right-of-use asset to be nil (no future tax relief is granted). Its carrying amount is initially \$15 million (ignoring the advanced payment) and so a taxable temporary difference of \$15 million arises which creates a deferred tax liability.

The tax base of the lease liability is nil (\$15m carrying amount less \$15m future tax relief). The carrying amount of the lease liability is \$15 million, so a deductible temporary difference of \$15 million arises, which would create a deferred tax asset.

This transaction is not a business combination and it affects neither accounting profit nor taxable profit. However, equal amounts of deductible and taxable temporary differences are created.

A deferred tax asset would be recognised for \$3 million ($$15m \times 20\%$), assuming that sufficient future profits are expected against which the difference can be utilised. A deferred tax liability would also be recognised for \$3 million.

The entry required is:

Dr Deferred tax assets \$3m

Cr Deferred tax liabilities \$3m.

The initial advanced payment is considered for deferred tax purposes separately from the recognition of the right-of-use asset and lease liability. The advance rental of \$4m is included in the right-of-use asset but not the lease liability. The carrying amount of the right-of-use asset increases by \$4m. The tax base is nil. This is a taxable temporary difference of \$4 million.

The advance payments do not affect accounting profit, but they do affect taxable profit as tax relief is granted as the cash is paid, so a deferred tax liability will need to be recorded. A deferred tax liability is recognised for 0.8 million ($4m \times 20$ %). A corresponding tax expense is recognised in the statement of profit or loss.

Dr Tax expense (P/L) \$0.8m

Cr Deferred tax liabilities \$0.8m

	Marking guide		
			Marks
(a)	(i) – discussion of the collectability of consideration – discussion of performance obligations		2
		Maximum	5
	(ii) — application of the above principles to:		2 3 2
		Maximum	7
(b)	Discussion of the following: - Sustainability reporting developments e.g. SDGs, other initiat - Specific Zedtech factors: - high tech industry - new region - workers' rights - equality - use of sustainable materials	ives (GRI etc)	1 5
	 other sensible, scenario based factors importance to stakeholders and management 		2
		Maximum	8
(c)	Identification of taxable and deductible temporary differences Journal (deferred tax asset and deferred tax liability) Deferred tax on advance payment separately accounted Journal or reference to tax recognised in profit or loss		2 1 1 1
		Maximum	5
Total			25

Examiner's comments

Where a question requires a discussion of the principles of IFRS 15 to determine the recognition of for instance two software packages (one with distinct contracts for hardware and software, the other where hardware is integral to the software), candidates should ensure that they apply those principles to the scenario. For example, some candidates are still providing a IFRS 15 'list' rather than further explaining the importance of each step with regard to recognition.

Those candidates that applied the principles of IFRS 15 to the scenario – and distinguished between the separate performance obligations in one contract and the integrated performance obligation in the second contract – scored well in their explanation and application.

45 FILL (DEC 2018)



Key answer tips

Parts (a) and (c) both require reference to the Conceptual Framework. This is a key topic in SBR that is being tested heavily. Make sure that you read Chapter 1 in the Study Text thoroughly.

(a) (i) Conceptual Framework

The *Conceptual Framework* acknowledges two measurement bases: historical cost, and current value. Net realisable value (NRV) is a current value measurement. However, the *Conceptual Framework* is not an accounting standard and so, in order to determine NRV, the directors would need to refer to IAS 2 *Inventories*.

(ii) Net realisable value

IAS 2 defines NRV as the estimated selling price in the ordinary course of business less the costs of completion and costs of sale. In this case, the NRV will be determined on the basis of conditions which existed at the date of the statement of financial position.

NRV will be based upon the most reliable estimate of the amounts which will be realised for the coal. The year-end spot price will provide good evidence of the realisable value of the inventories and where the company has an executory contract to sell coal at a future date, then the use of the forward contract price may be appropriate. However, if the contract is not executory but is a financial instrument under IFRS 9 *Financial Instruments* or an onerous contract recognised as a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, it is unlikely to be used to calculate NRV.

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

(b) Replacement costs

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

Provision

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

Impairment

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

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

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

(c) Control

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

Although the *Conceptual Framework* gives some guidance on the definition of control, existing IFRS Standards should be used when making the assessment.

IFRS 10 Consolidated Financial Statements states that an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Fill does not have control over the mine because its voting power is not sufficient for it to pass operating decisions that will affect the mine's relevant activities and thus its returns.

However, in accordance with IFRS 11 *Joint Arrangements*, it would seem that joint control exists. This is because two of the parties (Fill and the participant that owns 35%) share control and operating decisions require them to unanimously agree. The mine does not appear to be a separate entity and would therefore most likely be classified as a joint operation.

Business Combinations

A business combination is defined in IFRS 3 *Business Combinations* as a transaction or other event in which an acquirer obtains **control** of one or more businesses. A business is defined as an integrated set of activities and assets capable of being managed to provide outputs. The mine does represent a business. However, the Fill's purchase of a 40% interest is not a business combination because Fill does not have control.

That said, IFRS 3 states that the accounting treatment of the acquisition of an interest in a joint operation that meets the definition of a business should apply the same principles as are applied to a business combination unless those principles contradict IFRS 11. In other words, the identifiable net assets of the joint operation should be measured at fair value. However, unlike with a business combination, Fill should not recognise any non-controlling interest. Instead, Fill should only recognise its share of the mine's assets and liabilities. Goodwill would be recognised for the difference between the consideration paid for the interest and Fill's share of the net assets acquired.

	Marking guide				
		Marks			
(a)	 a discussion of potential measurement basis, NRV and relevant Standards 	4			
	application of IAS 2 to the scenario	3			
1					
		7			
(b)	a discussion of IAS 16 and application to the scenario	4			
	 a discussion of IAS 36 and application to the scenario 	4			
		8			
(c)	 a discussion of control in the ED Conceptual Framework and other relevant Standards 	4			
	 a discussion of a business combination per IFRS 3 	2			
	 application of the above discussions to the scenario 	4			
		10			
T-4-'		35			
Total		25			

Examiner's comments

The key to answering the first part of the question (and most questions) was to use the information in the scenario. The scenario mentioned that the entity sells its coal on the spot and futures markets and that low quality coal is to be extracted in three years' time when the forecast price of coal is to be 20% lower than the current spot price. Candidates could gain marks by simply discussing how this information would impact on coal valuation. In addition, candidates could gain marks by discussing the variety of measurement bases set out in the Conceptual Framework and how these might be applied to inventory valuation.

This second part of the question was well answered by candidates. However, the same cannot be said for the third part of the question which tested joint control and whether the Conceptual Framework affected the decision over the control of the mine. The wording of the question was such that it gave candidates the scope for a wide discussion of the issues involved. For example, candidates could have discussed the Conceptual Framework and the guidance on the definition of control. Additionally, existing IFRS standards also provide help in determining control via IFRS 10 Consolidated Financial Statements. IFRS 3 Business Combinations discusses the situation where an acquirer obtains control of one or more businesses. Unfortunately most candidates took a narrow approach and discussed mainly IFRS 10 or IFRS 3. However, if a candidate concluded differently to the model answer, and substantiated this, then credit was given.

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



Key answer tips

Many students who sat the exam in December 2018 found this question difficult. There are definitely some tricky elements within in. However, part of the problem no doubt resulted from issues with exam technique and exam preparation.

Part (a) is relatively straight-forward, but 'management commentary' is a current issue and many students do not study this area of the syllabus adequately. Current issues feature in every SBR exam; do not neglect them.

Part (b) appears tricky but actually offers some very easy sources of marks. For example, all students sitting SBR should be able to 'provide an explanation of accounting for deferred taxation'. Make sure that you concentrate on the parts of the question that you are most comfortable with.

(a) (i) Management commentary



Tutorial note

Management commentary is listed as a 'current issue' within the SBR syllabus. Do not neglect this area of the syllabus when studying. Current issues feature in every SBR exam.

The IFRS Practice Statement *Management Commentary* provides a broad, non-binding framework for the presentation of management commentary. The Practice Statement is not an IFRS Standard. Consequently, entities applying IFRS Standards are not required to comply with the Practice Statement, unless specifically required by their jurisdiction. Furthermore, non-compliance with the Practice Statement will not prevent an entity's financial statements from complying with IFRS Standards.

Arguments against non-binding approach



Tutorial note

You should be able to generate some points here using common-sense.

A mandatory standard is more likely to guarantee a consistent application of its principles and practices. Some entities will not produce management commentary because its application is non-mandatory. It can therefore be argued that the Board's objectives of enhancing the comparability of financial information will not be achieved unless management commentary is mandatory.

Arguments for non-binding approach



Tutorial note

Remember that a non-binding approach will permit greater flexibility. Whilst this can be a drawback, it can also lead to the disclosure of more relevant information.

It is difficult to create a standard on the MC which is sufficiently detailed to cover the business models of every entity or be consistent with all IFRS Standards. The Practice Statement allows companies to adapt the information provided to particular aspects of their business. This flexible approach could help generate more meaningful disclosures about resources, risks and relationships which can affect an entity's value and how these resources are managed. It provides management with an opportunity to add context to the published financial information, and to explain their future strategy and objectives without being restricted by the constraints of a standard.

Some jurisdictions take little notice of non-mandatory guidance but the Practice Statement provides local regulators with a framework to develop more authoritative requirements.

If the MC were a full IFRS Standard, the integration of management commentaries and the information produced in accordance with IFRS Standards could be challenged on technical grounds, as well as its practical merits.

(ii) Understandability

The *Conceptual Framework* states that financial information should be readily understandable. The MC should therefore be written in plain language and a style appropriate to users' needs.

The form and content of the MC will vary between entities, reflecting the nature of their business, the strategies adopted and the regulatory environment in which they operate. Whatever the form and content, users should be able to locate information relevant to their needs.

Relevance



Tutorial note

Begin by defining 'relevance' as per the Conceptual Framework.

Information has the quality of relevance when it has the capacity to influence the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. Relevant financial information has predictive value, confirmatory value or both.

The onus is on management to determine what information is important enough to be included in the MC to enable users to 'understand' the financial statements and meet the objective of the MC. If the entity provides too much information, it could reduce its relevance and understandability. If material events or uncertainties are not disclosed, then users may have insufficient information to meet their needs.

However, unnecessary detail may obscure important information especially if entities adopt a boiler-plate approach. If management presents too much information about, for example, all the risks facing an organisation, this will conflict with the relevance objective. There is no single optimal number of disclosures but it is useful to convey their relative importance in a meaningful way.

Comparability



Tutorial note

Begin by defining comparability as per the Conceptual Framework.

Comparability is the qualitative characteristic which enables users to identify and understand similarities and differences amongst items. It is important for users to be able to compare information over time and between entities. Comparability between entities is problematic as the MC is designed to reflect the perspectives of management and the circumstances of individual entities. Thus, entities in the same industry may have different perceptions of what is important and how they measure and report it. There are some precedents on how to define and calculate non-financial measures and financial measures which are not produced in accordance with IFRS Standards but there are inconsistencies in the definition and calculation of these measures.

It is sometimes suggested that the effectiveness of the overall report may be enhanced by strengthening the links between financial statements and the MC. However, such suggestions raise concerns about maintaining a clear distinction between the financial statement information and other information.

An entity should ensure consistency in terms of wording, definitions, segment disclosures, etc. between the financial statements and the MC to improve the understanding of financial performance.

(b) Current tax

Current tax is based on taxable profit for the year. Taxable profit is different from accounting profit due to temporary differences between accounting and tax treatments, and due to items which are never taxable or tax deductible. Tax benefits such as tax credits are not recognised unless it is probable that the tax positions are sustainable.

The Group is required to estimate the corporate tax in each of the many jurisdictions in which it operates. The Group is subject to tax audits in many jurisdictions; as a result, the Group may be required to make an adjustment in a subsequent period which could have a material impact on the Group's profit for the year.

Tax reconciliation



Tutorial note

Discuss the tax reconciliation, what it shows, and why it is useful.

The tax rate reconciliation is important for understanding the tax charge reported in the financial statements and why the effective tax rate differs from the statutory rate.

Most companies will reconcile the group's annual tax expense to the statutory rate in the country in which the parent is based. Hence the rate of 22% is used in the tax reconciliation. It is important that the reconciliation explains the reasons for the differences between the effective rate and the statutory rate.



Tutorial note

Remember to state the obvious. The 'other' category is vague and does not provide useful information to financial statement users.

There should be minimal use of the 'other' category. In this case, the other category is significant (\$14 million) and there is no explanation of what 'other' constitutes. This makes it harder for investors to predict the Group's tax expense in future periods.

One-off and unusual items can have a significant effect on the effective tax rate, but financial statements and disclosure notes rarely include a detailed discussion of them. For example, the brand impairment and disposals of businesses should be explained to investors, as they are probably material items. The explanation should include any potential reversal of the treatment.

Some profits recognised in the financial statements are non-taxable. In some jurisdictions, gains on disposals of businesses are not taxable and impairment losses do not obtain tax relief. These issues should be explained to investors so that they understand the impact on the Group's effective tax rate.

Tax rates



Tutorial note

To make investment decisions, investors need information that will help them to assess an entity's future cash flows. Tax paid is a significant annual cash flow, so information about different tax rates is important.

As the Group is operating in multiple countries, the actual tax rates applicable to profits in those countries are different from the local tax rate. The overseas tax rates are higher than local rates, hence the increase in the taxation charge of \$10 million. The local rate is different from the weighted average tax rate (27%) of the Group based on the different jurisdictions in which it operates. Investors may feel that using the weighted tax rate in the reconciliation gives a more meaningful number because it is a better estimate of the tax rate the Group expects to pay over the long term. Investors will wish to understand the company's expected long-term sustainable tax rate so they can prepare their cash flow or profit forecasts.

Information about the sustainability of the tax rate over the long term is more important than whether the rate is high or low compared to other jurisdictions. An adjustment can be made to an investor's financial model for a long-term sustainable rate, but not for a volatile rate where there is no certainty over future performance.



Tutorial note

Volatility in financial statements makes it harder for investors to predict an entity's future net cash flows.

For modelling purposes, an understanding of the actual cash taxes paid is critical and the cash paid of \$95 million can be found in the statement of cash flows.

Deferred taxation



Tutorial note

Easy marks can be obtained for outlining the accounting treatment of deferred tax.