Provision for deferred tax is made for temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and their value for tax purposes. The amount of deferred tax reflects the expected recoverable amount and is based on the expected manner of recovery or settlement of the carrying amount of assets and liabilities, using the basis of taxation enacted or substantively enacted by the financial statement date.

Deferred tax assets are not recognised where it is more likely than not that the assets will not be realised in the future. The evaluation of deferred tax assets' recoverability requires judgements to be made regarding the availability of future taxable income.

Management assesses the available evidence to estimate if sufficient future taxable income will be generated to use the existing deferred tax assets. A significant piece of objective negative evidence evaluated was the loss incurred in the period prior to the period ended 30 November 20X7. Such objective evidence may limit the ability to consider other subjective evidence such as projections for future growth.

Deferred taxes are one of the most difficult areas of the financial statements for investors to understand. Thus there is a need for a clear explanation of the deferred tax balances and an analysis of the expected timing of reversals. This would help investors see the time period over which deferred tax assets arising from losses might reverse. It would be helpful if the company provided a breakdown of which reversals would have a cash tax impact and which would not.

Application of deferred tax rules to Holls

As the proposed tax law was approved, it is considered to be enacted. Therefore, the rate of 25% should be used to calculate the deferred tax liability associated with the relevant items which affect deferred taxation.

Tutorial note

Use the information in the question to calculate the deferred tax balances.

At 30 November 20X7, Holls has deductible temporary differences of \$4.5 million which are expected to reverse in the next year. In addition, Holls also has taxable temporary differences of \$5 million which relate to the same taxable company and the tax authority. Holls expects \$3 million of those taxable temporary differences to reverse in 20X8 and the remaining \$2 million to reverse in 20X9. Thus a deferred tax liability of \$1.25 million (\$5 million × 25%) should be recognised and as \$3 million of these taxable temporary differences are expected to reverse in the year in which the deductible temporary differences reverse, Holls can also recognise a deferred tax asset for \$0.75 million (\$3 million × 25%). The recognition of a deferred tax asset for the rest of the deductible temporary differences will depend on whether future taxable profits sufficient to cover the reversal of this deductible temporary difference are expected to arise. An entity is permitted to offset deferred tax assets and deferred tax liabilities if there is a legally enforceable right to offset the current tax assets against current tax liabilities as the amounts relate to income tax levied by the same taxation authority on the same taxable entity.

After the enactment of a new tax law, when material, Holls should consider disclosing the anticipated current and future impact on their results of operations, financial position, liquidity, and capital resources. In addition, Holls should consider disclosures in the critical accounting estimates section of the management commentary to the extent the changes could materially affect existing assumptions used in making estimates of tax-related balances. Changes in tax laws and rates may affect recorded deferred tax assets and liabilities and the effective tax rate in the future.

Marking guide

			Marks
(a)	(i) –	arguments for and against the non-binding framework	4
	(ii) –	a discussion of understandability, relevance and comparability	3
	–	application of the above characteristics to MC	2
			5
(b)	–	an explanation of why taxable profits are different from accounting profit	2
	–	application of the following explanations to the scenario:	
		tax reconciliation	4
		tax rates	3
		deferred taxation	5
			14
	Professional marks		2
Total			**25**

Examiner's comments

There were a range of answers available to the first part of the question and candidates were given due credit if they were able to justify their conclusions. Many candidates did not actually answer the requirement but instead simply described a management commentary or defined the qualitative characteristics. They did this without applying their knowledge to the preparation of the management commentary. Due credit was given to this type of answer but of course, full marks cannot be awarded unless the question set is actually answered.

The second part of the question caused some candidates concern and yet it was well answered. The syllabus area requires candidates to demonstrate synthesis and evaluation and not simply factual knowledge. The model answer sets out significantly more than was required to gain a good mark. Likewise, candidates were also awarded marks for points raised which were not included in the model answer. By their nature, questions on an investor perspective are going to produce variations in answers because investors have many different perspectives and may even require different information from that provided in the financial statements.

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

Key answer tips

The *Conceptual Framework* is an important topic in the SBR syllabus. You need to learn its contents but also practise applying it to each of the examinable IFRS and IAS Standards.

The SBR syllabus requires you to be able to discuss the current framework for integrated reporting, including the objectives, concepts, guiding principles and content of an integrated report. Do not neglect this popular exam topic.

(a) (i) IAS 38 recognition criteria

Tutorial note

You should know the recognition criteria in all of the examinable IFRS and IAS Standards. This is core knowledge.

IAS 38 *Intangible Assets* defines an intangible asset as a non-monetary asset without physical substance. It requires an entity to recognise an intangible asset if:

- it is probable that expected future economic benefits will flow to the entity, and
- the cost of the asset can be measured reliably.

This requirement applies whether an intangible asset is acquired externally or generated internally. 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. The probability recognition criterion is always considered to be satisfied for intangible assets which are acquired separately or in a business combination.

If the recognition criteria are not met, IAS 38 requires the expenditure to be expensed when it is incurred.

Conceptual Framework

Tutorial note

The Conceptual Framework was revised in 2018. Make sure that your knowledge here is up-to-date. The current definitions of assets and liabilities make no reference to the probability of economic inflows or outflows.

According to the *Conceptual Framework,* items are only recognised if they meet the definition of an element. The definition of an asset is '**a present economic resource controlled by an entity as a result of a past event**' (para 4.3).

This does not mean that all items meeting the definition of an element are recognised. An element is only recognised if recognition provides users with useful financial information. In other words recognition must provide:

- relevant information
- a faithful representation of the asset or liability, and resulting income, expenses or equity movements.

Recognition might not provide relevant information if there is uncertainty over the existence of the element or if there is a low probability of an inflow or outflow of economic resources. Recognition of an element might not provide a faithful representation if there is a very high degree of measurement uncertainty.

Consistency

As can be seen, the recognition criteria in the *Conceptual Framework* and IAS 38 are different. This is because the recognition criteria in IAS 38 were based on previous versions of the *Conceptual Framework*, and have not been updated to reflect the 2018 *Conceptual Framework*.

Tutorial note

The recognition criteria in many other IFRS and IAS Standards are also based on the previous version of the Conceptual Framework. The Board may revise these standards in the future.

Both IAS 38 and the *Conceptual Framework* attempt to ensure that financial statements provide information that meets the qualitative characteristics of useful information but do this in different ways. IAS 38 uses practical filters of probability and reliability to exclude information that will not be useful. In contrast, the *Conceptual Framework* refers directly to the qualitative characteristics, and provides guidance on how to apply them.

The *Conceptual Framework* does not override IAS 38. The *Conceptual Framework* is only applied by preparers of financial statements when no standard applies to a particular transaction. Transactions involving intangible assets fall within the scope of IAS 38 and so the recognition criteria in this standard will be applied.

Tutorial note

Remember that one of the key purposes of the Conceptual Framework is to assist the Board when developing or revising an IFRS Standard.

(ii) Implications if recognition criteria were met

> ***Tutorial note***
>
> *Capitalisation is not optional. Expenditure that meets the criteria in IAS 38 must be recognised as an intangible asset, unless the effect is immaterial.*

Skizer should have assessed whether the recognition criteria in IAS 38 were met at the time the entity capitalised the intangible assets. If the recognition criteria were met, then it was not appropriate to derecognise the intangible assets. According to IAS 38, an intangible asset should be derecognised only on disposal or when no future economic benefits are expected from its use or disposal.

If there were any doubts regarding the recoverability of the intangible asset, then Skizer should have assessed whether the intangible assets would be impaired. IAS 36 *Impairment of Assets* would be used to determine whether an intangible asset is impaired.

Further, the reclassification of intangible assets to research and development costs does not constitute a change in an accounting estimate. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that a change in accounting estimate is an adjustment of the carrying amount of an asset or liability, or related expense, resulting from reassessing the expected future benefits and obligations associated with that asset or liability. The costs of the stakes in the development projects can be determined and will not have been estimated.

Implications if recognition criteria were not met

> ***Tutorial note***
>
> *If a mistake was made on initial recognition, then this would constitute a prior period error.*

If it is believed that the transactions never met the recognition criteria in IAS 38 then Skizer would have to recognise retrospectively a correction of an error, in accordance with IAS 8.

(iii) Sale of intangible

Revenue is defined in IFRS 15 *Revenue from Contracts with Customers* as income arising from a company's ordinary activities.

There is no indication that Skizer's business model is to sell development projects. Skizer's business model is to jointly develop a product, then leave the production to partners. Moreover, if the asset was for sale in the ordinary course of business then it would have been classified on acquisition as inventory. Skizer recognised an intangible asset, and fully impaired the asset, so it cannot argue that it has thereafter been held for sale in the ordinary course of business.

Tutorial note

Intangible assets are non-current assets. If an asset is held for sale in the ordinary course of business then, per IAS 1 Presentation of Financial Statements, it is presented as a current asset (most likely as inventories).

Furthermore, IAS 38 prohibits presenting the proceeds from the disposal of an intangible asset as revenue.

(b) (i) Issues with intangible assets acquired in a business combination

Tutorial note

This is a tricky requirement, but you are not expected to answer in the same level as detail as the model answer below. Seven separate points across the three issues would be sufficient to score full marks.

Under IFRS 3 *Business Combinations*, acquired intangible assets must be recognised and measured at fair value if they are separable or arise from other contractual rights. Once recognised, IAS 38 requires intangible assets with finite lives to be amortised over their useful lives and intangible assets with indefinite lives to be subject to an annual impairment review in accordance with IAS 36.

However, it is unlikely that all intangible assets acquired in a business combination will be homogeneous and investors may feel that there are different types of intangible assets which may be acquired. For example, a patent may only last for a finite period of time and may be thought as having an identifiable future revenue stream. In this case, amortisation of the patent would be logical. However, there are other intangible assets which are gradually replaced by the purchasing entity's own intangible assets, for example, customer lists, and it may make sense to account for these assets within goodwill. In such cases, investors may wish to reverse amortisation charges. In order to decide whether an amortisation charge makes sense, investors require greater detail about the nature of the identified intangible assets. IFRS Standards do not permit a different accounting treatment for this distinction.

Issues with choice in accounting policy

Tutorial note

Remember that measurement choices within IFRS Standards limit comparability because it is harder to compare one entity with another.

IAS 38 requires an entity to choose either the cost model or the revaluation model for each class of intangible asset. Under the cost model, after initial recognition intangible assets should be carried at cost less accumulated amortisation and impairment losses. Under the revaluation model, intangible assets may be carried at a revalued amount, based on fair value, less any subsequent amortisation and impairment losses.

The revaluation model can only be used if there is an active market for the intangible asset. Such active markets are not common for intangible assets.

Tutorial note

An active market is one where identical assets are regularly traded and prices are readily available.

If an intangible asset is reported using the cost model, the reported figures for intangible assets such as trademarks may be understated when compared to their fair values.

Moreover, the ability to choose the revaluation model or the cost model may limit comparability between different entities.

Capitalisation of development expenditure

Tutorial note

In real life, the distinction between 'research' and 'development' may not be clear cut. Moreover, performance related bonuses or stock market pressure may be incentives to classify research expenditure as development.

IAS 38 requires all research costs to be expensed. Development costs must be capitalised if the technical and commercial feasibility of the asset for sale or use has been established.

If an entity cannot distinguish the research phase of an internal project to create an intangible asset from the development phase, the entity treats the expenditure for that project as if it were incurred in the research phase only. This cautious approach ensures that assets are not overstated.

The problem for investors is that companies do not have a consistent approach to capitalisation. It is often unclear from disclosures how research expenditure was distinguished from development expenditure. It may be that entities allow bias to impact their decision-making in this area.

Intangible asset disclosure can help analysts understand the innovation capacity of companies. Investors can use the disclosure to identify companies with valuable development assets – once these launch in the market they should generate economic benefits, potentially increasing investment returns. However, preparers of financial statements are failing to adequately comply with the disclosure requirements of IAS 38, which limits their usefulness.

(ii) Integrated reporting

> ***Tutorial note***
>
> *An integrated report communicates an entity's value creation in the short, medium, and long-term. It conceptualises value in terms of a range of capitals (stocks of value), rather than just in terms of financial capital.*

Measuring the contribution of intangible assets to future cash flows is fundamental to integrated reporting. This helps explain the gap between the carrying amount of an entity's net assets and its market equity value.

As set out above, organisations are required to recognise intangible assets acquired in a business combination. Consequently, the intangible assets are only measured once for this purpose. However, organisations are likely to go further in their integrated report and disclose the impact on intangible assets as a result of sustainable growth strategies or specific initiatives. It is therefore very useful to communicate the value of intangible assets in an integrated report. For example, an entity may decide to disclose its assessment of the increase in brand value as a result of a corporate social responsibility initiative.

Marking scheme

			Marks
(a)	(i)	Discussion of recognition criteria	**5**
	(ii)	Derecognition criteria and impairment	2
		Reclassification and estimates	2
		If criteria not met	1
			5
	(iii)	Consideration of Skizer's business model	2
		Application of IFRS 15	2
			4
(b)	(i)	Different types of intangibles	3
		Cost or revaluation	2
		Development or research	2
			7
	(ii)	Measurement in financial statements	2
		Discussion of whether IR can supplement financial statements	2
			4
Total			**25**

Examiner's comments

Candidates should be able to discuss the consistency of the Conceptual Framework with each IFRS that is examined. Part (a)(i) is a good illustration of how candidates can be tested on this. Answers to this section were weak in general.

Answers to part (a)(ii) were generally weak. Some candidates missed that the question specifically referred to the recognition criteria being met, in which case derecognition would be inappropriate. Very few candidates identified the need for an impairment review under IAS 36 *Impairment of Assets* if there were doubts over recoverability from the intangible assets.

Answers to part (b) were generally good, where discussion included the accounting choices and subjective aspects of IAS 38 and IFRS 3. However, some answers limited opportunities for marks by not considering both standards. Part (b)(ii) asked for a discussion on whether integrated reporting can enhance reporting for intangible assets. Whilst many candidates were familiar with integrated reporting, fewer applied it to the situation (relating to intangible assets).

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

Key answer tips

Additional performance measures (APMs) are increasingly prominent in the financial statements of public limited entities. The SBR syllabus states that students need to be able to discuss and apply APMs. Part (a) of this question should be a source of easy marks because lots of common-sense points can be made.

Part (b) is trickier. Many students dislike statements of cash flows and so would struggle to correct the errors made by Daveed. There are four marks available in part (b) (i) and part (b) (ii) – so you only need to post two correct adjustments on each to score a pass mark. Deal with the easiest adjustments first. If you don't understand an issue then leave it and move on.

(a) APMs

(i) APMs are not defined by International Financial Reporting Standards and therefore may not be directly comparable with other companies' APMs, including those in the same industry. If the same category of material items recurs each year and in similar amounts (in this example, restructuring costs and impairment losses) then the reporting entity should consider whether excluding these amounts from underlying profit provides a faithful representation of economic performance.

Under IFRS Standards, items cannot be presented as 'extraordinary items' in the financial statements or in the notes. Thus it may be confusing to users of the APMs to see this term used.

Tutorial note

Many entities are quick to classify expenses as non-recurring. Relatively few entities classify incomes as 'non-recurring'. Why do you think this is?

Items such as restructuring costs or impairment losses should not be labelled as non-recurring where it is misleading. The entity can make an adjustment for a charge or gain which they believe is appropriate, but they cannot describe such adjustments inaccurately.

(ii) The deduction of capital expenditure, purchase of own shares and the purchase of intangible assets from cash flows from operating activities is acceptable because free cash flow does not have a uniform definition.

A clear description of free cash flow and a reconciliation showing how this measure is calculated should be disclosed so that users can draw conclusions about the usefulness of the APM.

Entities should avoid misleading comments when describing APMs. Free cash flow does not normally represent the residual cash flow available as many entities have mandatory debt service requirements which are not normally deducted from the measure. It would also be misleading to show free cash flow per share in bold alongside earnings per share as they are not comparable.

(iii) When an entity presents an APM, it should present the most directly comparable measure calculated in accordance with IFRS Standards with equal or greater prominence. Whether an APM is more prominent would depend on the facts and circumstances. In this case, the entity has omitted comparable information calculated in accordance with IFRS Standards from an earnings release which includes APMs such as EBITDAR. Additionally, the entity has emphasised the APM measure by describing it as 'record performance' without an equally prominent description any measure calculated in accordance with IFRS Standards. Further, the entity has provided a discussion of the APM measure without a similar discussion and analysis of the IFRS Standards measure.

The entity has presented EBITDAR as a performance measure; such measures should be reconciled to profit for the year as presented in the statement of comprehensive income. Operating profit would not be considered the best starting point as EBITDAR makes adjustments for items which are not included in operating profit such as interest and tax.

Tutorial note

Comparability is an important characteristic of useful financial information. The users of financial statements should be able to compare the financial performance and position of one entity with another. They should also be able to compare the same entity year-on-year.

The entity has changed the way it calculates the APM because it has treated rent differently. However, if an entity chooses to change an APM, the change and the reason for the change should be explained and any comparatives restated. A change would be appropriate only in exceptional circumstances where the new APM better achieves the same objectives, perhaps if there has been a change in the strategy. The revised APM should be reliable and more relevant.

(iv) The entity should provide income tax effects on its APMs depending on the nature of the measures. The entity should include current and deferred income tax expense commensurate with the APM and the APM should not be presented net of tax as income taxes should be shown as a separate adjustment and explained.

(b) (i) Adjustment of net cash generated from operating activities for errors in the statement

Tutorial note

Label your workings so that the marker can understand the adjustments you have made.

	$m
Draft net cash generated from operations (per question)	278
Cash inflows relating to car disposals	30
Effects of changes in foreign exchange rates	28
Reclassification of interest paid	18
Tax credit not recorded	6
Associate's profit – incorrectly included	(12)
Share of associate's profit – non-cash item that should have been deducted from profit.	(4)
Net cash generated from operating activities	344

(ii) Free cash flow reconciliation

Tutorial note

The question tells you how to calculate operating 'free cash flow'. Make sure you read note (vi) carefully.

In note (iv) we are told that the pension deficit payments are 'exceptional'. It is easy to miss this. Daveed excludes exceptional items when calculating free cash flow.

	$m
Net cash generated from operating activities (part (i))	344
Net capital expenditure	(46)
Purchase of associate (W1)	(20)
Dividend received from associate (25% × $4m)	1
Interest received	10
Interest paid	(18)
Pension deficit payments – add back to exclude	27
Free cash flow	298

(W1) Purchase of associate

	$m
Purchase cost (bal. fig.)	20
Share of profit of associate	4
Dividend received	(1)
Carrying amount as at 31 August 20X8	23

(iii) Explanation of adjustments

Tutorial note

There is only one mark available for each issue. Keep your explanations brief.

Purchase and sale of cars

Daveed's presentation of cash flows from the sale of cars as being from investing activities is incorrect as cash flows from the sale of cars should have been presented as cash flows from operating activities ($30 million). IAS 16 *Property, Plant and Equipment* (PPE) states that an entity which normally sells items of PPE which are held for rental to others should transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. Subsequent proceeds from the sale of such assets should be recognised as revenue in accordance with IFRS 15 *Revenue from Contracts with Customers* and thus shown as cash flows from operating activities.

Purchase of associate

Cash paid for the investment is $20 million, and cash received from the dividend is $1 million. In order to arrive at the correct figure for net cash generated from operating activities, the incorrect treatment of the profit for the year for the associate must be eliminated ($12 million) and the correct adjustment of $4 million shown in net cash generated by operating activities.

Foreign exchange losses

IAS 7 *Statement of Cash Flows* states that unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. The amounts reported in the statement of cash flows included, in error, the effect of changes in foreign exchange rates arising on the retranslation of its overseas operations. As a consequence, cash generated from operating activities should be increased by $28 million. All exchange differences relating to the subsidiary are recorded in other comprehensive income and taken to a separate component of equity. On disposal of the foreign operation the gains (or losses) are reclassified to the statement of profit or loss.

Pension payments

The pension payments are correctly included in operating cash flows. However, Daveed excludes them when calculating free cash flow. As the tax cash benefit has not been included, net cash generated from operating activities will be adjusted for the $6 million and $27 million ($33m – $6m) will be excluded from the free cash flow calculation.

Interest paid

Interest paid which is capitalised as part of the cost of property, plant, and equipment should be treated as a cash flow from investing activities. Interest paid and capitalised as part of inventory should be classified within operating activities the statement of cash flows. Thus there should be a reclassification of interest paid of $18 million from the operating section to the investing activities section.

Marking scheme

			Marks
(a)		Discussion of comparability of APMs	1
		Extraordinary items	2
		Free cash flow	2
		EBITDAR	4
		Tax effects	1
			10
(b)	(i)	Adjustment schedule	**4**
	(ii)	Free cash reconciliation	**4**
	(iii)	Purchase of cars	1
		Purchase of associate	1
		Foreign exchange losses	1
		Pension payments	1
		Interest paid	1
			5
		Professional marks	**2**
Total			**25**

Examiner's comments

It was pleasing to see that part (a) was often well-described, reasoned and applied to the scenario. However, answers to part (b) were more varied.

49 PLAYER TWO

Key answer tips

Part (a) of this question tests management performance measures. This topic appears in the SBR specimen paper 1 (the original pilot paper). Make sure that you have read about their use and legitimacy. Marks are available for general points, as well as for raising specific issues with Player Two's performance measures.

Part (b) requires assessment of a financial statement disclosure. Users of the financial statements want information that is entity specific rather than generic. What else do you think Wrap's investors would want to know about the impairment review?

(a) Management performance measures

IAS 1 *Presentation of Financial Statements* permits entities to disclose additional information that is relevant to understanding an entity's performance and position. The *Conceptual Framework* notes that the primary users of financial statements are investors, lenders and other creditors.

Management performance measures are often used internally when assessing management performance. As such, they can help financial statement users to understand management's view about what is important to the entity. However, there are concerns about their use.

It is commonly argued that management performance measures are used to disguise weak financial performance, which may mislead financial statement users. This criticism might apply to Player Two. Basic earnings per share (EPS) is 2.0 cents per share ($2.5m/122.2m), whereas adjusted basic EPS is more than five times higher.

Management performance measures can be particularly misleading if displayed prominently. This is because they may become indistinguishable from figures produced in accordance with IFRS Standards and therefore obtain unwarranted credibility. Although Player Two does not disclose this performance measure on the face of its primary statements the ordering of disclosure notes is important and the disclosure of this information may still mislead investors as to its nature.

Performance measures that use figures prepared in accordance with IFRS Standards are more likely to be comparable with other entities. Entities may differ markedly when calculating management performance measures. For example, the types of adjustments made by Player Two when calculating adjusted basic EPS may differ from those used by other entities, hindering comparability. One company's performance measures may also not be comparable year-on-year.

Some entities do not reconcile their management performance measures back to the financial statements. However, this criticism does not apply to Player Two. As such, it is possible to assess the adequacy and reasonableness of the adjusting items.

Some users may question the appropriateness of the profit adjustments that Player Two has made to arrive at adjusted basic EPS:

- Although amortisation is a judgemental, non-cash expense, the business may need to replace its intangible assets. This will require investment. Moreover, amortisation of brands should reflect their pattern of use. If brands have a definite useful life then the business will need to incur costs in order to protect its brand positioning and market share.
- Restructuring costs were incurred in both the current and prior periods and so they are not a one-off cost. Excluding these amounts from underlying basic EPS ignores the fact that restructuring is a regular part of Player Two's business.
- The existence of impairment charges suggests that the retail stores have performed poorly and are under-utilised. It also suggests a poor outlook for the business in terms of its future net cash inflows. Eliminating this impairment charge when calculating adjusted basic EPS could be argued to provide an over-optimistic representation of Player Two's current and future performance.

(b) Impairment disclosures

Impairment reviews involve judgement and therefore the users of the financial statements must be provided with enough information to assess whether the assumptions used were reliable.

The disclosure note is lacking key information about many of the judgements used. It is very generic and does not provide information that is specific to Wrap's impairment review.

Cash-generating unit

No information has been provided about how the cash generating unit was determined.

No information has been provided about how goodwill was allocated to the cash generating unit.

Value-in-use

The disclosure note does not describe key assumptions factored into the cash flow forecast and therefore the users cannot assess its reliability. Important assumptions might include estimates of future margins or, if relevant, foreign currency movements.

The disclosure does not say whether the forecasts represent past experience or future expectations. It also does not state whether there is any consistency with external sources of information.

The disclosure note does not say how many years the cash flow forecasts covered. This is important because forecasts that cover a longer period are less likely to be reliable.

The note does not say how many years' worth of cash flows have been extrapolated beyond the end of the budgeted period. The longer this period, the less likely it is that the growth rate will be maintained, due to obsolescence issues or the entrance of new competitors to the market.

The disclosure note does not justify the rate of growth used to extrapolate cash flows beyond the period covered by the cash flow forecasts. This is important because the growth rate used seems unrealistically high, particularly when compared to the current economic climate and the sluggish performance of the industry within which Wrap operates.

The disclosure does not state whether the growth rate used is specific to Unit D. Growth could therefore be over or under-stated.

Wrap have disclosed an average discount rate. They should instead disclose the specific rate used to discount the cash flows of Unit D so that users can assess whether it appears reasonable. The discount rate used should reflect the time value of money and the risks specific to the CGU for which future cash flow estimates have not been adjusted.

Sensitivity

The market capitalisation of Wrap is below its net asset value, suggesting that the market is expecting impairment in value. This would contradict the disclosure, which says that a 'reasonably possible change' would not cause impairment.

Sensitivity analysis would therefore be of use to the users so that they assess the likelihood and impact of potential future impairments.

Marking scheme

		Marks
(a)	Player Two's performance measures	15
(b)	Impairment disclosure	10
		–––
Total		**25**
		–––

50 MEHRAN *Walk in the footsteps of a top tutor*

Key answer tips

Part (a) requires an in-depth knowledge of IFRS 13 *Fair Value Measurement*. As with all narrative based questions, you need to demonstrate both your knowledge of the standard and your ability to apply it to real-life scenarios.

(a) (i) IFRS 13 and non-financial assets

Tutorial note

IFRS 13 Fair Value Measurement says that the fair value of a non-financial asset is based on its 'highest and best use'. This is an important concept. Fair value is also a market-based measurement, rather than one which is entity specific.

IFRS 13 *Fair Value Measurement* requires the fair value of a non-financial asset to be measured based on its highest and best use. This is determined from the perspective of market participants. It does not matter whether the entity intends to use the asset differently.

The highest and best use takes into account the use of the asset which is physically possible, legally permissible and financially feasible. IFRS 13 allows management to presume that the current use of an asset is the highest and best use unless factors suggest otherwise.

Land

If the land zoned for agricultural use is currently used for farming, the fair value should reflect the cost structure to continue operating the land for farming, including any tax credits which could be realised by market participants. Thus the fair value of the land if used for farming would be \$5.1 million (\$5m + \$0.1m).

The agricultural land appears to have an alternative use as market participants have considered its use for residential purposes instead. A use of an asset need not be legal at the measurement date, but it must not be legally prohibited in the jurisdiction.

If used for residential purposes, the value should include all costs associated with changing the land to the market participant's intended use. In addition, demolition and other costs associated with preparing the land for a different use should be included in the valuation. These costs would include the uncertainty related to whether the approval needed for changing the usage would be obtained, because market participants would take that into account when pricing value of the land if it had a different use. Thus the fair value of the land if used for residential purposes would be \$5.44 million ((\$7.4m – \$0.2m – \$0.3m – \$0.1m) × 80%).

In this situation, the presumption that the current use is the highest and best use of the land has been overridden by the market factors which indicate that residential development is the highest and best use. Therefore the fair value of the land would be \$5.44 million.

Brand

In the absence of any evidence to the contrary, Mehran should value the brand on the basis of the highest and best use by market participants, even if Mehran intends a different use.

Market participants would not discontinue the brand, because their existing brands are less strong. Instead market participants would continue to use the brand in order to obtain the direct benefits.

Mehran's decision to discontinue the brand is therefore not relevant in determining fair value. As such, the fair value of the brand is \$17 million.

(ii) IFRS 13 and financial assets

Tutorial note

This part of the question can be answered well using common-sense. How do Mehran's ordinary shares differ from the preferred shares? What impact will these differences have on their fair value?

IFRS 13 *Fair Value Measurement* states that fair value is a market-based measurement, although it acknowledges that observable market transactions might not be available. Whether or not observable information is available, the aim of IFRS 13 is to estimate the price at which an asset would be sold at in an orderly transaction between market participants at the measurement date.

The market approach takes a transaction price paid for an identical or a similar instrument and adjusts it. Using a market approach, Mehran could take the transaction price for the preferred shares and adjust it to reflect certain differences between the preferred shares and the ordinary shares. For example:

- There would be an adjustment to reflect the priority of the preferred shares upon liquidation.
- Mehran should acknowledge the benefit associated with control. This adjustment relates to the fact that Mehran's individual ordinary shares represent a non-controlling interest whereas the preferred shares issued reflect a controlling interest.
- There will be an adjustment for the lack of liquidity of the investment which reflects the lesser ability of the ordinary shareholder to initiate a sale of Erham relative to the preferred shareholder.
- There will be an adjustment for the cumulative dividend entitlement of the preferred shares. This would be calculated as the present value of the expected future dividend receipts on the preferred shares, less the present value of any expected dividend receipts on the ordinary shares.

Mehran should review the circumstances of the issue of the preferred shares to ensure that its price was a valid benchmark. In addition, Mehran should consider whether there have been changes in market conditions between the issue of the preferred shares and the measurement date.

(b) Accounting for provisions

Tutorial note

The question requires you to explain the accounting treatment of provisions. This should be a source of easy marks.

Provisions are defined in IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets* as liabilities where the timing or the amount of the future outflow is uncertain. A provision is recognised if all of the following criteria are met:

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

Provisions should be measured at the best estimate of the economic resources required to settle the obligation. They should be remeasured at each reporting date using the best available information. If the time value of money is material then the provision should be discounted to present value. The discount rate used should reflect risks specific to the liability.

Benefits and limitations

Tutorial note

Imagine you are an investor. What useful information about future cash flows and risks can you get from the disclosure? What other information would you like to know?

Provisions involve uncertainty. Disclosures should provide important information to help users understand the nature of the obligation, the timing of any outflow of economic benefits, uncertainties about the amounts or timing involved, and major assumptions made.

The disclosure note splits the provision between current and non-current liabilities. This helps users of the financial statements assess the timing of the cash outflows and the potential impact on Mehran's overall net cash inflows. It would be useful to provide further information about the expected timing of the outflows classified as a non-current liability.

Financial reporting focusses on past events, but provisions disclosures also provide important information about the future. This disclosure note informs investors about restructuring activities within stores, but also in Finance and IT. Whilst this restructuring will incur costs, investors may value Mehran's efforts to streamline its operations and improve efficiency.

The disclosure shows that provisions, as a total balance, increased year on year. Liabilities always entail risk because there is an obligation to make payments to settle the obligation even if the company has insufficient liquid resources to do so. Provisions might be viewed as particularly risky, because they are estimated and therefore the actual cash outflows required might be significantly higher than estimated. Some investors may be deterred from investing in companies with substantial provisions.

With regards to the refund provision, the amount utilised in the reporting period is less than the provision at the start of the year. This suggests that, in the prior year, management had over-estimated the refund provision. This information may cast doubt on management's ability to accurately estimate its provisions and increase uncertainty regarding Mehran's future cash flows.

Further information could be provided to help users assess the adequacy of the provisions made. Part of the restructuring provision is classified as non-current but no information is provided about discount rates. Very little information is provided about any uncertainties that would impact the measurement of the provision, or the assumptions made. This hinders the ability of the users to assess the adequacy of management's estimates.

Marking scheme			
			Marks
(a)	(i)	Non-financial assets and fair value – 1 mark per point	9
	(ii)	Financial assets and fair value – 1 mark per point	6
(b)		Provisions accounting – 1 mark per point	3
		Benefits and limitations – 1 mark per point	5
		Professional marks	2
Total			**25**

51 CARSOON

Key answer tips

Part (a) of this question requires a good knowledge of IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers.* Part (b) examines the accounting implications of a contemporary scenario, and so it falls within the 'current issues' section of the syllabus.

(a) (i) Financial asset

According to IFRS 9 *Financial Instruments,* debt instruments measured at FVOCI are measured at fair value in the statement of financial position. Interest income is calculated using the effective interest rate. Fair value gains and losses on these financial assets are recognised in other comprehensive income (OCI).

Expected credit losses (ECLs) do not reduce the carrying amount of the financial assets, which remains at fair value. Instead, an amount equal to the ECL allowance is recognised in OCI.

When these financial assets are derecognised, the cumulative gains and losses previously recognised in OCI are reclassified from equity to profit or loss.

The fair value of the debt instrument therefore needs to be ascertained at 28 February 20X7. IFRS 13 *Fair Value Measurement* states that Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities which the entity can access at the measurement date. The standard sets out that adjustment to Level 1 prices should not be made except in certain circumstances. It would seem that a Level 1 input is available so there is no reason to use the 'in house' model.

Therefore the accounting for the instrument should be as follows:

- The bonds will be initially recorded at $6 million
- Interest of $0.24 million will be received and credited to profit or loss.
- At 28 February 20X7, the bonds will be valued at $5.3 million. The loss of $0.7 million will be charged as an impairment loss of $0.4 million to profit or loss and $0.3 million to OCI.
- When the bond is sold for $5.3 million on 1 March 20X7, the financial asset is derecognised and the loss in OCI ($0.3 million) is reclassified to profit or loss.

(ii) Revenue recognition

IFRS 15 *Revenue from Contracts with Customers* specifies how to account for costs incurred in fulfilling a contract which are not in the scope of another standard. These are divided into those which give rise to an asset and those which are expensed as incurred. Entities will recognise an asset when costs incurred to fulfil a contract meet certain criteria, one of which is that the costs are expected to be recovered. For costs to meet the 'expected to be recovered' criterion, they need to be either explicitly reimbursable under the contract or reflected through the pricing of the contract and recoverable through the margin.

General and administrative costs cannot be capitalised unless these costs are specifically chargeable to the customer under the contract. Similarly, wasted material costs are expensed where they are not chargeable to the customer. Therefore a total expense of $15 million will be charged to profit or loss and not shown as assets.

A penalty is a form of variable consideration. The penalty payable should be estimated and deducted from the transaction price if it is highly probable that a significant reversal in the amount of revenue recognised will not occur when the uncertainty is resolved.

The construction of the separate storage facility is a distinct performance obligation; the contract modification for the additional storage facility would be, in effect, a new contract which does not affect the accounting for the existing contract. When the contract is modified for the construction of the storage facility, an additional $7 million is added to the consideration which Carsoon will receive. The performance obligation has been satisfied so this revenue can be recognised in full.

(b) Financial reporting implications

The flood has damaged production machinery and caused a decline in production output. Per IAS 36 *Impairment of Assets*, this is an indication of impairment. As such, an impairment review must be performed in which the carrying amount of the assets is compared to the recoverable amount. The recoverable amount is the higher of fair value less costs to sell and value in use. Individual assets do not generate cash flows, so it is likely that the assets will need to be tested as part of the cash generating unit to which they belong. Any impairment of the cash generating unit will be firstly allocated to goodwill and then to other assets in proportion to their carrying amounts. No asset can be impaired below the higher of zero and its recoverable amount. Impairment losses are charged to profit or loss, unless they relate to an asset for which a specific revaluation surplus exists.

According to IAS 2 *Inventories*, inventory must be valued at the lower of cost and net realisable value (NRV). If the damaged inventory cannot be sold then it should be written off entirely and the loss charged to cost of sales in the statement of profit or loss. If the inventory can be fixed and resold then the necessary costs should be factored in when determining NRV.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that contingent assets are disclosed in the financial statements if economic benefits are probable. As such, Sinkton should disclose information about the insurance claim and an estimate of the proceeds that will be received.

According to IAS 37, recognition of a provision is dependent on the existence of a present obligation arising from a past event. As such, no provision can be recognised for future operating losses. Moreover, a provision cannot yet be recognised for restructuring. This is because, at the reporting date, there is no detailed, formal plan in place and therefore Sinkton does not have a constructive obligation to restructure.

As a result of the flooding, it would seem that the useful life of the building has reduced. The useful life of an asset, per IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, is an accounting estimate. As such, amending the useful life is accounted for prospectively and will lead to higher depreciation charges in profit or loss for the remainder of the current period and in future periods.

Cash flow problems may give rise to going concern uncertainties. IAS 1 *Presentation of Financial Statements* states that going concern uncertainties should be disclosed in the notes to the financial statements.

Marking scheme

			Marks
(a)	(i)	Financial asset – 1 mark per point	8
	(ii)	Revenue – 1 mark per point	7
(b)		Natural disasters – 1 mark per point	10
Total			**25**

52 SKYE

Key answer tips

Part (a) requires a good knowledge of two key topics: classifying a financial instrument as debt or equity, and deferred tax. Part (b) is about the *Conceptual Framework*, which is a fundamental part of the SBR syllabus.

(a) (i) Debt or equity

Tutorial note

This is a very common exam topic. Make sure that you know the definition of a financial liability and are able to apply it. Revisit the Study Text if your knowledge is lacking.

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

In the case of the B shares, Skye has no obligation to transfer cash or another asset to the holders of the instruments. Therefore the B shares should be classed as equity. The fact that Skye has not refused redemption in the past does not cause the B shares to be classified as a liability since this does not create a contractual obligation on Skye.

The preference shares create an obligation for Skye because of the put option clause in the agreement. The fact that Skye may not be in a position to satisfy the put option feature because of insufficient distributable reserves does not negate the fact that Skye has an obligation.

(ii) Deferred tax

Tutorial note

Deferred tax is calculated by comparing the carrying amount of an asset or liability with its tax base. An important first step is therefore to calculate the carrying amount of the property at the reporting date. Remember that the overseas property is a non-monetary item and so is initially translated into the functional currency of Skye at the historic rate and is not retranslated.

According to IAS 12 *Income Taxes*, deferred tax is accounted for on temporary differences between the financial reporting treatment of a transaction and the tax treatment.

The property of the overseas branch is written down at different rates in the financial statements than it is for tax purposes, giving rise to a temporary difference. A temporary difference may also arise if the carrying amounts of the non-monetary assets of the overseas branch are translated at different rates to the tax base.

The property is a non-monetary asset and so, according to IAS 21 *The Effects of Changes in Foreign Exchange Rates*, is translated into Skye's functional currency using the historic rate and is not retranslated. This means that the asset would initially be recorded at \$1.2 million (D6m/5).

IAS 16 *Property, Plant and Equipment* requires that the asset is depreciated over its useful life. The carrying amount of the asset at the reporting date is therefore \$1.1 million (\$1.2m × 11/12).

The tax base of the property at the reporting date is D5.25 million (D6m × 7/8). If translated at the closing rate, this gives \$0.875 million (D5.25m/6).

There is a taxable temporary difference of \$0.225 million (\$1.1m – \$0.875m). The deferred tax balance will be calculated using the tax rate in the overseas country. The deferred tax liability arising is \$45,000 (\$0.225m × 20%), which will increase the tax charge in profit or loss.

(b) (i) Prudence

Tutorial note

You should be able to give a definition of prudence for some easy marks.

Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates. Prudence is generally taken to mean that assets or income are not overstated and liabilities or expenses are not understated.

Exercising prudence can lead to increased subjectivity in the financial statements, which will affect the evaluation of the entity's performance. Deliberate understatement or deliberate overstatement of the financial statements, even in the name of prudence, is not neutral. Overstating liabilities and expenses in the current period will lead to higher reported profits in the next reporting period. As such, this would not offer a faithful representation of an entity's financial performance and position.

However, to offer a faithful representation, financial statements should be free from bias. Preparers of financial statements have a natural bias towards optimism – often as a result of incentives to report higher profits and/or assets – and therefore prudence might counteract this. Investors are often concerned about financial risk relating to potential losses and so some form of conservatism certainly has a role to play in financial reporting.

(ii) Measurement

Tutorial note

The purpose of financial reporting is to provide information to users that will help them to make decisions about advancing economic resources to an entity. To be useful, the information must embody the fundamental qualitative characteristics.

The *Conceptual Framework* identifies two broad measurement bases: historical cost and current value.

When selecting a measurement base, preparers of the financial statements should ensure that the resulting financial information is as useful as possible to primary user groups. To be useful, financial information must be relevant and it must faithfully represent an entity's underlying transactions.

To maximise relevance, preparers of financial statements should consider the characteristics of the asset or liability they are measuring. In particular, they should consider how the asset contributes to future cash flows, and whether those cash flows are sensitive to market factors.

Depreciated cost is unlikely to provide relevant information about an asset with a volatile market value that will be traded in the short-term. Similarly, reporting an asset or liability at fair value will not provide relevant information if the item is held to collect contractual cash flows.

In order to faithfully represent an entity's transactions, consideration must be given to measurement uncertainty. This arises when estimation techniques are used. If measurement uncertainty is too high then information provided by that measurement basis is unlikely to be useful.

When selecting a measurement basis, preparers of financial statements should consider whether the benefits of the information it provides to the users of the financial statements outweigh the costs providing that information.

Tutorial note

Don't forget about the enhancing qualitative characteristics of useful financial information. These should be maximised where possible.

Consideration should also be given to the enhancing qualitative characteristics of useful financial information. Using the same measurement basis as other entities in the same sector would enhance comparability. Using many difference measurement bases in a set of financial statements reduces understandability. Verifiability is maximised by using measurement bases that can be corroborated.

Marking scheme

			Marks
(a)	(i)	Debt or equity – 1 mark per point	6
	(ii)	Deferred tax – 1 mark per point	7
(b)	(i)	Prudence – 1 mark per point	6
	(ii)	Selecting a measurement base – 1 mark per point	6
Total			**25**

53 WHITEBIRK

Key answer tips

Part (a) (i) should be relatively straight forward because it tests knowledge from the Financial Reporting paper. However, part (a) (ii) requires knowledge of the differences between full International Financial Reporting Standards and the IFRS for SMEs Standard. Many students neglect this area of the syllabus. All of the examinable content can be found in the Study Text.

You can score relatively well on the practical considerations in part (b) using common sense. The financial statement implications, however, are trickier. Try and refer to specific accounting standards, otherwise your answer is likely to be too generic.

(a) (i) Borrowing costs

IAS 23 *Borrowing Costs* requires borrowing costs incurred when acquiring or constructing an asset to be capitalised if the asset takes a substantial period of time to be prepared for its intended use or sale.

The definition of borrowing costs includes interest expense calculated by the effective interest method, finance charges on leases and exchange differences arising from foreign currency borrowings relating to interest costs.

Borrowing costs should be capitalised during construction and include the costs of funds borrowed for the purpose of financing the construction of the asset, and general borrowings which would have been avoided if the expenditure on the asset had not occurred. The general borrowing costs are determined by applying a capitalisation rate to the expenditure on that asset.

The weighted-average carrying amount of the machine during the period is \$3.5 million (\$2m + \$3m + \$4m + \$5m) / 4). The capitalisation rate of the borrowings of Whitebirk during the period of construction is 9% per annum. The total amount of borrowing costs to be capitalised is the weighted-average carrying amount of the stadium multiplied by the capitalisation rate. This amounts to \$0.1 million (\$3.5 million × 9% × 4/12).

(ii) Research and development

According to IAS 38 *Intangible Assets*, research expenditure does not give rise to probable economic benefits and therefore no intangible asset should be recognised. The \$1 million research expenditure should be written off to profit or loss.

IAS 38 requires development expenditure to be capitalised as long as certain criteria are met. The project must give rise to probable economic benefits, the entity must have sufficient resources to complete development, and the expenditure incurred must be able to be measurable. Assuming the criteria are met, the \$0.5 million expenditure should be capitalised as an intangible asset. The asset should be amortised to profit or loss to reflect its pattern of use by the entity.

SMEs Standard

Borrowing costs

In accordance with the SMEs Standard, borrowing costs are always expensed to the statement of profit or loss. Therefore, none of the borrowing costs incurred as a result of the construction of the machine can be capitalised.

Research and development expenditure

The SMEs Standard states that an entity must recognise expenditure incurred internally on an intangible item, including all expenditure on both research and development activities, as an expense when it is incurred. Thus the expenditure of \$1.5 million on research and development would all be written off to profit or loss.

(b) (i) Practical considerations

When implementing a new accounting standard, an entity should prepare an impact assessment and project plan. The entity may need to spend money on training staff, or on updating or replacing its systems. New processes and controls may need to be developed and documented.

New accounting standards will most likely contain new recognition, measurement and disclosure requirements. If the impact of these is not communicated then investors' assessments of how management has discharged its stewardship responsibilities may change and this could affect their investment decisions. As such, management should communicate the impact of a new standard to investors and other stakeholders – particularly if it will result in lower profits or increased liabilities.

Banking agreements often specify maximum debt levels or financial ratios based on figures reported in the financial statements. New financial reporting requirements can affect those ratios, causing potential covenant breaches.

Dividends could be affected. Many jurisdictions have regulations, which restrict the amount which can be paid out in dividends. This restriction is normally based on accounting profits.

The impact of adopting a new IFRS Standard should be communicated to analysts. Some governments use information prepared under IFRS standards for statistical and economic planning purposes.

Competitive advantage could be lost if a new financial reporting standard requires extensive disclosures.

Bonus schemes may need to be re-assessed because the new standard could affect the calculation of performance-related pay.

Financial statement implications

Where there is the introduction of a new accounting standard, the financial statements will need to reflect the new recognition, measurement and disclosure requirements which, in turn, will mean that entities will need to consider the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8 contains a requirement that changes in accounting policies are fully applied retrospectively unless there are specific transitional provisions contained in the new IFRS Standard being implemented.

IAS 1 *Presentation of Financial Statements* requires a third statement of financial position to be presented if the entity retrospectively applies an accounting policy, restates items, or reclassifies items, and those adjustments had a material effect on the information in the statement of financial position at the beginning of the comparative period.

IAS 33 *Earnings per Share* requires basic and diluted EPS to be adjusted for the impacts of adjustments resulting from changes in accounting policies accounted for retrospectively and IAS 8 requires the disclosure of the amount of any such adjustments.

A change in an accounting standard can change the carrying amounts of assets and liabilities, which will have deferred tax consequences.

(ii) First time adoption of IFRS Standards

IFRS 1 *First-time Adoption of IFRS* says that an entity must produce an opening statement of financial position in accordance with IFRS Standards as at the date of transition. The date of transition is the beginning of the earliest period for which an entity presents full comparative information under IFRS Standards in its first financial statements produced using IFRS Standards.

At the date of transition, the entity must:

- recognise all assets and liabilities required by IFRS Standards
- derecognise assets and liabilities not permitted by IFRS Standards
- reclassify assets, liabilities and equity in accordance with IFRS Standards
- measure assets and liabilities in accordance with IFRS Standards.

Gains or losses arising on the adoption of IFRS Standards at the date of transition should be recognised directly in retained earnings.

Marking scheme

		Marks
(a)	(i) IAS 23 and IAS 38 – 1 mark per point	8
	(ii) IFRS Standards vs. IFRS for SMEs Standard – 1 mark per point	4
(b)	(i) Practicalities of implementing new IFRS Standards – 1 mark per point	10
	(ii) IFRS 1	3
Total		**25**

54 BUSINESS COMBINATIONS *Walk in the footsteps of a top tutor*

Key answer tips

The two requirements in part (a) are worth a lot of marks. Broadly speaking, you will be awarded one mark for every valid point that you make. Ensure that you are making enough points to achieve at least a pass mark.

Always thoroughly read the model answer and learn from any mistakes that you made. If you lack the required technical knowledge then revisit the Study Text.

(a) (i) Saag and Aloo

Tutorial note

Should Saag have been accounted for Aloo as a business combination or an asset acquisition? This requires knowledge of the definition of a business per IFRS 3 Business Combinations. State this definition, and then apply it to the information provided in the question.

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

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

The optional concentration test is not met because the fair value of the total assets acquired is split between land and buildings, and equipment. These are different classes of PPE.

As such, Saag must engage in a more detailed assessment of whether Aloo constitutes a business.

Aloo does not currently produce outputs. The acquired processes are therefore only substantive if there is a knowledgeable and experienced workforce able to convert other acquired inputs into outputs. Although such a workforce has been transferred, in the absence of inventories or intellectual property this workforce is incapable of producing outputs. As such, the purchase of Aloo does not constitute a business combination and so the proposed treatment is incorrect.

(ii) Bimbi and Lental

Tutorial note

Remember that the acquirer in a business combination is the entity that exercises control. Easy marks can be obtained for stating the definition of control in IFRS 10.

IFRS 3 *Business Combinations* requires an acquirer to be identified in all business combinations. The acquirer is the combining entity which obtains control of the other combined entity.

IFRS 10 *Consolidated Financial Statements* says 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.

Sometimes it is straightforward to assess power by looking at the voting rights obtained. When the parent acquires more than half of the voting rights of the entity, it normally has power if the relevant activities of the investee are directed by a vote.

There is a presumption that an entity achieves control over another entity by acquiring more than one half of the voting rights, unless it can be demonstrated that such ownership does not constitute control.

Tutorial note

In more complicated scenarios, like the one in this question, IFRS 3 sets out further rules for determining the acquirer in a business combination.

You may struggle to remember the rules off by heart. If this is the case, then use your common sense. Which company issued equity in the transaction? Which company is the bigger of the two? Which company seems to control the other? As always, try and reach a justified conclusion.

If the guidance in IFRS 10 does not clearly indicate which of the combining entities is the acquirer then the indicators listed in IFRS 3 should be considered.

The acquirer is usually the entity which transfers cash or other assets. In this scenario, as Bimbi is the entity giving up a cash amount corresponding to 45% of the purchase price, this represents a significant share of the total purchase consideration.

When there is an exchange of equity interests in a business combination, the entity which issues the equity interests is normally the acquirer. In this case, as the majority of the purchase consideration is settled in equity instruments, Bimbi would appear to be the acquirer.

The acquirer is usually the combining entities whose shareholders retain or receive the largest portion of the voting rights in the combined entity. The shareholders of Bimbi, the smaller of the two combining entities, appear to have obtained control since their share amounts to 51% of the voting rights after the transaction. A controlling ownership, however, does not necessarily mean that the entity has the power to govern the combined entity's financial and operating policies so as to obtain benefits from its activities.

Additionally, the acquirer could be deemed to be the entity whose owners have the ability to appoint or remove a majority of the members of the governing body of the combined entity. Five out of six members of the board here are former board members of Bimbi, which again suggests that Bimbi is the acquirer.

Additionally, the acquirer could be deemed the entity whose former management dominates the management of the combined entity. However, the management team consists of the COO plus two former employees of Lental as compared to two former employees of Bimbi. Therefore, the former management of Lental has a greater representation. Although the board nominates the management team, the COO will have significant influence through his share ownership and the selection of the team.

IFRS 3 also says that the acquirer is often the larger entity. As the fair value of Lental ($90 million) is significantly greater than Bimbi ($70 million), this would point towards Lental as the acquirer.

The arguments supporting Bimbi or Lental as the acquirer are finely balanced and therefore it is difficult to identify an acquirer in this case. It can be argued that Bimbi can be identified as the acquirer, on the basis that:

- Bimbi issued the equity interest
- Bimbi is the entity transferring the cash or other assets and
- Bimbi has the marginal controlling interest (51%).

(b) Kata

Tutorial note

You have enough information to calculate the impact that consolidating Kata, or using the equity method, would have on the consolidated financial statements.

Subsidiary

If accounted for as a subsidiary:

- The assets, liabilities, incomes and expenses of Kata would be consolidated in full.
- Goodwill of \$1.92 million (W1) would be recognised.
- The group would recognise its share of Kata's post-acquisition retained earnings. This amounts to \$0.27 million (45% × (\$2m – (\$2.4m – \$1.0m)).
- The group would recognise a non-controlling interest in respect of Kata of \$1.65 million (W2).

Associate

If accounted for as an associate, the investment in Kata at the year-end would be carried at \$3.27 million (W3).

In the statement of profit or loss, the group would show its share of Kata's profit of \$0.27 million (W3).

Comparison of impact

Tutorial note

Don't just calculate figures. Make sure that you explain and compare the likely impact of the classification decision on the users' perceptions of the consolidated financial statements.

Assets

Consolidating Kata would lead to a higher non-current asset position than if equity accounting was used (PPE of \$14 million and goodwill of \$1.92 million compared with an investment in the associate of \$3.27 million).

This will make the group look more asset rich, which may help it to raise finance in the future.

However, consolidating Kata's large PPE balance may have a detrimental impact on the group's non-current asset turnover, thus making the group look less efficient at generating profits.

Liabilities

Consolidating the loans of Kata may have a negative impact on the group's gearing ratio. This may have the effect of making the group look riskier than if equity accounting was used. A higher gearing ratio may make it harder for the group to raise finance in the future.

Profit or loss

Consolidating the incomes and expenses of Kata line by line will impact key profit or loss figures, such as revenue, gross profit and profit from operations. Increased revenues will make the group's market share look more impressive.

Kata is profitable so consolidating its results will improve the group's profit from operations. This may have a positive impact on investor perception.

If Kata was accounted for using the equity method, the group would simply shows its share of Kata's profits as a single line below profit from operations. This would therefore have no impact (positive or negative) on the group's operating profit.

Workings

Tutorial note

Always show your workings.

(W1) Goodwill

	$m
Consideration	3.0
NCI at acquisition (55% × $2.4m)	1.32
Fair value of net assets at acquisition	(2.40)
Goodwill	1.92

(W2) Non-controlling interest

	$m
NCI at acquisition	1.32
NCI % of post-acq'n net assets 55% × ($3m – $2.4m)	0.33
	1.65

(W3) Investment in associate

	$m
Cost	3.0
Group % of post-acq'n P/L 45% × ($2m – ($2.4m – $1.0m))	0.27
	3.27

Note: The same answer could be obtained by taking the group's share of the post-acquisition movement in the associate's net assets (equivalent to the movement in its share capital and retained earnings).

Marking scheme			
			Marks
(a)	(i)	Business combinations – 1 mark per point	7
	(ii)	Identifying the acquirer – 1 mark per point	8
(b)	Comparison of consolidation and equity accounting – 1 mark per point		8
	Professional marks		2
Total			**25**

55 MARGIE *Walk in the footsteps of a top tutor*

Key answer tips

This is a multi-part question which focuses upon application of IFRS 2 *Share-based Payment*. Each part is self-contained, so can be answered in the order you prefer. Remember to clearly identify which part you are answering, particularly if you are answering them out of order. The marks attributable for each part of the question give a good indication of how to allocate your time.

(a) (i) Share-appreciation rights

Tutorial note

There are key differences between the accounting treatment of cash-settled share-based payments and equity-settled share-based payments. Make sure that you learn the rules thoroughly.

The scope of IFRS 13

IFRS 13 *Fair Value Measurement* applies when another IFRS or IAS Standard requires or permits fair value measurements or disclosures about fair value measurements. IFRS 13 specifically excludes transactions covered by certain other standards including share-based payment transactions within the scope of IFRS 2 *Share-based Payment*.

Thus share-based payment transactions are scoped out of IFRS 13.

Accounting for the SARs

Tutorial note

The question asks you to 'advise'. Lots of students jump straight into calculations – don't forget the words!

For cash settled share-based payment transactions, the entity should recognise an expense and liability as service is rendered. The fair value of the liability is measured at each reporting date. Any changes in fair value are recognised in profit or loss in the period.

Tutorial note

Show all workings. This will help you to score marks even if you make a mistake.

The SARs would have been accounted for during the vesting period as follows:

Year	**Expense**	**Liability**	**Calculation**
	$	$	
30 April 20X3	641,250	641,250	(300 × 95%) × 500 × $9 × ½
30 April 20X4	926,250	1,567,500	(300 × 95%) × 500 × $11

Until the liability is settled, the entity must re-measure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period.

	$
Liability 1 May 20X4	1,567,500
Cash paid (60 × 500 × $10.50)	(315,000)
Expense (bal. fig.)	97,500
Liability 30 April 20X5 ((285 – 60) × 500 × $12)	1,350,000

The fair value of the liability would be $1,350,000 at 30 April 20X5 and the expense for the year would be $97,500.

(ii) Share transactions

Tutorial note

This part of the question contains two separate transactions – one with shareholders and one with a supplier. Ensure that you address both issues in turn.

A share-based payment is when an entity receives goods or services in exchange for equity instruments or cash based on the value of equity instruments

The shares issued to the employees were issued in their capacity as shareholders and not in exchange for their services. The employees were not required to complete a period of service in exchange for the shares. Thus the transaction is outside the scope of IFRS 2 *Share-based Payment*.

As regards to Grief, Margie approached the company with the proposal to buy the building in exchange for shares. As such the transaction comes under IFRS 2. Grief is not an employee so the transaction will be recorded at the value of the goods received. This means that the building is recognised at its fair value and equity will be credited with the same amount.

(iii) Wheat contract

Tutorial note

Determine whether or not the transaction falls within the scope of IFRS 2. If not, explain why not and then continue by discussing the required accounting treatment.

The arrangement is not within the scope of IFRS 2 *Share-based Payment* because Margie is not expecting to take delivery of the wheat.

This contract is within the scope of IFRS 9 *Financial Instruments* because it can be settled net and was not entered into for the purpose of the receipt or delivery of the item in accordance with the entity's expected purchase, sale, or usage requirements.

The contract is a derivative because it meets the following criteria:

- Its value changes compared to an underlying item
- It required no, or a low, initial investment
- It is settled in the future

Tutorial note

Don't stop your answer once you've concluded that the contract is a derivative. Make sure that you explain how derivatives are initially and subsequently measured.

IFRS 9 *Financial Instruments* requires derivatives to be measured at fair value through profit or loss, unless the entity applies hedge accounting.

The contract will be initially recognised at fair value. This will probably be nil as, under the terms of a commercial contract, the value of 2,500 shares should equate to the value of 350 tonnes of wheat.

Derivatives are remeasured to fair value at each reporting date, with the gain or loss reported in the statement of profit or loss. The fair value will be based on the values of wheat and Margie shares. The fair value gain or loss should be recorded in the statement of profit or loss.

(b) Share-based payment

> ***Tutorial note***
>
> *Start with the definition of an 'expense'.*

The *Conceptual Framework* defines an expense as a decrease in economic benefits that result in decreases in equity (other than those related to distributions to equity participants).

In the case of a cash-settled share-based payment, the entity has an obligation to pay cash in the future. This therefore meets the definition of an expense.

However, in the case of an equity-settled share-based payment, the entity is providing equity as payment for the good or service received. There is no apparent reduction in an asset or increase in a liability in accordance with the definition of an expense. In fact, an equity-settled share-based payment has no net impact on equity (expenses reduce retained earnings, but the other side of the transaction increases other components of equity). Although IFRS 2 *Share-based Payment* requires the recognition of an expense for equity-settled schemes, it can be argued that this is not in accordance with the definitions in the *Conceptual Framework*.

The Board refute the above. They argue that employee service is an asset that is received by the reporting entity but then simultaneously consumed. In other words, in accordance with the definition of an expense, there is a decrease in the assets of the reporting entity.

Non-refundable deposits

> ***Tutorial note***
>
> *Start with the definition of a 'liability'.*

The *Conceptual Framework* defines a liability as a present obligation from a past event to transfer an economic resource.

In this example, there is no obligation to repay the cash because the deposit is non-refundable. Some commentators believe that the deposit amount should therefore be recognised immediately as income.

Nonetheless, the seller has an obligation to transfer the related goods or services to the customer. These goods or services are economic resources because they have the potential to produce economic benefits. As such, a non-refundable deposit received would seem to meet the definition of a liability.

That said, it can be argued that the liability to transfer goods or services should be recognised at the cost to the entity of providing these, rather than the price that was charged to the customer.

Internally generated brands

Tutorial note

This part is about the recognition of an asset. Therefore state the definition of an asset and the principles that govern the recognition of elements in the financial statements.

The *Conceptual Framework* defines an asset as a resource controlled by an entity as a result of a past event. Brands, whether internally generated or purchased, meet the definition of an asset. This is because they are controlled by the entity, normally through trademarks, and they have the potential to bring economic resources.

The *Conceptual Framework* says that items are recognised in the financial statements if recognition provides relevant information and a faithful representation of the underlying transaction. Recognition of a brand in the financial statements would most likely provide relevant information. Non-recognition arguably understates the financial value of the reporting entity to the primary users of the financial statements. However, the cost of an internally generated brand cannot be measured reliably because brand expenditure cannot be differentiated from the day-to-day operating costs of the business. This measurement uncertainty means that it is not possible to represent the brand faithfully in the financial statements.

The prohibition in IAS 38 on recognising internally generated brands would appear to be consistent with the *Conceptual Framework*.

Marking scheme

			Marks
(a)	(i)	Share appreciation rights – 1 mark per point	6
	(ii)	Share transactions – 1 mark per point	5
	(iii)	Wheat contract – 1 mark per point	7
(b)	Conceptual Framework – 1 mark per point		7
Total			**25**

56 KAYTE

Key answer tips

Broadly speaking, you will be awarded one mark for every valid point that you make. Ensure that you are making enough points to achieve at least a pass mark.

As always, make sure that you thoroughly debrief the answer and learn from any mistakes that you made.

(a) Vessels

Residual values

IAS 16 *Property, Plant and Equipment* defines residual value as the estimated amount which an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already at the age and in the condition expected at the end of its useful life. IAS 16 requires the residual value to be reviewed at least at the end of each financial year end. If the estimated residual value is higher than an asset's carrying amount then no depreciation is charged.

Vessels with 10 year useful life

Kayte's calculation of the residual value of the vessels with a 10-year useful life is not acceptable under IAS 16 *Property, Plant and Equipment*. Undesirable volatility is not a convincing argument to support the use of a residual value equivalent to half of the acquisition cost. The residual value should be the value at the reporting date as if the vessel were already of the age and in the condition expected at the end of its useful life. Kayte should prepare a new model to determine residual value which would take account of broker valuations at the end of each reporting period.

Vessels with 30 year useful life

As regards the vessels which are kept for the whole of their economic life, a residual value based upon the scrap value of steel is acceptable. Therefore the vessels should be depreciated based upon the cost less the scrap value of steel over the 30-year period.

When major planned maintenance work is to be undertaken, the cost should be capitalised. The engine overhaul will be capitalised as a new asset which will then be depreciated over the 10-year period to the next overhaul. The depreciation of the original capitalised amount will typically be calculated such that it had a carrying amount of nil when the overhaul is undertaken.

This is not the case with one vessel, because work was required earlier than expected. In this case, any remaining carrying amount of the old engine and overhaul cost should be expensed immediately.

Funnels

The initial carve out of components should include all major maintenance events which are likely to occur over the economic life of the vessel. Sometimes, it may subsequently be found that the initial allocation was insufficiently detailed, in that not all components were identified. This is the case with the funnels. In this situation it is necessary to determine what the carrying amount of the component would currently be had it been initially identified. This will sometimes require the initial cost to be determined by reference to the replacement cost and the associated accumulated depreciation charge determined using the rate used for the vessel. This is likely to leave a significant carrying amount in the component being replaced, which will need to be written off at the time the replacement is capitalised.

(b) (i) Selection of KPIs

The Integrated Reporting Framework does not specify which KPIs should be disclosed, or how they should be disclosed, but instead leaves this to management judgement. However, the Integrated Reporting Framework does identify characteristics of useful quantitative indicators.

KPIs should be focussed on matters that management have identified as material. They should be consistent with the KPIs used internally by management.

KPIs should be presented with comparative figures so that users of the <IR> can appreciate trends. Targets should also be disclosed, as well as projections for future periods.

The KPIs selected should be consistent with those used within the industry in which the entity operates.

The same KPIs should be reported each period, unless they are no longer material. KPIs should be calculated in a consistent manner in each reporting period.

Qualitative information and discussion is required to add context to KPIs, such as the assumptions used and the reasons for significant trends.

(ii) Interpretation of KPIs

Tutorial note

Imagine that you are a user of Kayte's <IR> – what conclusions might you draw? There are no right or wrong answers here. You will score one mark for every sensible point that you make. Make sure that you say at least seven different things.

The average employee salary has risen by 1.2%. This is less than the rate of inflation. Although the statistic could be skewed by high earners, it suggests that employees are earning less in real terms than they were a year ago.

Despite this, revenue per employee has increased by 14%. This suggests that there have been large scale measures to improve efficiency. There may be many reasons for this increase, such as technological changes, or new contracts. However, when combined with the small year-on-year pay increase, this extra workload could cause employee dissatisfaction.

The KPIs on sick days corroborate the above. Sick days per employee have increased by 133.3%. This may be suggestive of high levels of stress, potentially caused by the dramatic rise in efficiency, or simply the fact that many employees are not enjoying their jobs. Employee turnover has increased, and it is now in excess of the industry average. Once again, this may suggest dissatisfaction with pay or working conditions. It may be that Kayte's competitors offer more attractive employment terms.

Kayte is reliant on a skilled workforce, but the KPIs suggest that it needs to take measures to reduce absenteeism and to improve employee retention. Kayte appears to be losing a large number of its staff, which is ultimately not sustainable. A lack of experienced staff in the business will have a detrimental impact on the quality of the service provided by Kayte and a negative impact on its reputation. Users of the <IR> may therefore be pessimistic about Kayte's long-term prospects.

Marking scheme			
			Marks
(a)	Vessels– 1 mark per point		11
(b)	(i)	Selection of KPIs – 1 mark per point	4
	(ii)	Interpretation of KPIs – 1 mark per point	8
	Professional marks		2
Total			**25**

57 VERGE *Walk in the footsteps of a top tutor*

Key answer tips

This question covers a number of different standards that are commonly examined. It is vital that you learn these thoroughly. Make sure that you state the relevant accounting rules for easy marks, before applying them to the information in the scenario.

(a) (i) Operating segments

Tutorial note

IFRS 8 Operating Segments is a standard applicable to listed entities. Its aim is to increase the usefulness of the information provided to the users by disaggregating the highly summarised information provided in the primary financial statements.

Even if you do not have a detailed knowledge of this standard, you should still be able to reach a sensible conclusion as to whether or not segments 1 and 2 should be aggregated.

IFRS *8 Operating Segments* states that reportable segments are those operating segments or aggregations of operating segments for which segment information must be separately reported. Aggregation of one or more operating segments into a single reportable segment is permitted (but not required) where certain conditions are met, the principal condition being that the operating segments should have similar economic characteristics. The segments must be similar in each of the following respects:

- the nature of the products and services
- the nature of the production processes
- the type or class of customer
- the methods used to distribute their products or provide their services
- the nature of the regulatory environment.

Segments 1 and 2 have different customers. The decision to award or withdraw a local train contract rests with the transport authority and not with the end customer, the passenger. In contrast, the decision to withdraw from a route in the inter-city train market would normally rest with Verge but would be largely influenced by the passengers' actions that would lead to the route becoming economically unviable. In view of the fact that the segments have different customers, the two segments do not satisfy the aggregation criteria above.

In the local train market, contracts are awarded following a competitive tender process, and, consequently, there is no exposure to passenger revenue risk. The ticket prices paid by passengers are set by a transport authority and not Verge. By contrast, in the inter-city train market, ticket prices are set by Verge and its revenues are, therefore, the fares paid by the passengers travelling on the trains. In this set of circumstances, the company is exposed to passenger revenue risk. This risk would affect the two segments in different ways but generally through the action of the operating segment's customer.

Therefore the economic characteristics of the two segments are different and so they should be reported as separate segments.

(ii) Revenue recognition

Tutorial note

If a customer is provided with a significant financing benefit, revenue is calculated by discounting the consideration receivable to present value.

Make sure that you pay careful attention to dates in this question. This is important for the discounting calculations as well as for determining that a prior period error has occurred.

Maintenance services are simultaneously received and consumed. According to IFRS 15 *Revenue from Contracts with Customers,* this means that revenue should be recognised over time based on progress towards the satisfaction of the performance obligation. Thus Verge must recognise revenue as work is performed throughout the contract life.

The length of time between the transfer of the promised services and the payment date suggests that there is a significant financing component. The consideration should be discounted to present value using the rate at which the customer could borrow.

In the year ended 31 March 20X2, Verge should have recorded revenue of \$2.6 million (\$1 million + (\$1.8 million × ($1/1.06^2$))). Since Verge has received \$1 million cash, a receivable of \$1.6 million should have been recognised.

In the year ended 31 March 20X3, revenue should be recorded at \$1.13 million (\$1.2 million × (1/1.06)). In addition, the discount on the receivable recognised in the year ended 31 March 20X2 must be unwound. Consequently, there will be interest income of \$96,000 (\$1.6 million × 6%).

Prior period error

Tutorial note

Students often miss prior period errors. Pay careful attention to dates.

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue, and
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include mathematical mistakes, mistakes in applying accounting policies and fraud. The fact that Verge only included $1 million of the revenue in the financial statements for the year ended 31 March 20X2 is a prior period error.

Verge should correct the prior period error retrospectively. In the financial statements for the year ended 31 March 20X3, the comparative amounts for the prior period should be restated.

(b) Proposed financing

Tutorial note

Start of by explaining the accounting treatment of these transactions. Will they impact profit? Will these instruments be classified as debt, or equity, or both?

Ordinary shares

Ordinary shares do not create a contractual obligation to deliver cash or another financial asset. As such, per IAS 32 *Financial Instruments: Presentation*, they are classified as equity on the statement of financial position. If equity increases then the gearing ratio will improve, which may make Verge's financing structure look less risky to its investors.

Dividends paid on equity shares have no impact on profits because they are charged directly to retained earnings. Dividends are, in substance, the distribution of the entity's profits to its shareholders.

Issuing equity shares will increase the number of ordinary shares in the basic earnings per share calculation. If the entity is not able to grow its profits then basic earnings per share may fall year-on-year. Investors might perceive this negatively because it is an indication that their future dividend returns will fall.

Convertible bonds

A bond that is redeemed in the form of cash or a fixed number of the entity's own equity shares has characteristics of debt and equity. According to IAS 32 *Financial Instruments: Presentation,* the issuer should 'split' the bond into a liability component and an equity component. The liability component is calculated by taking the cash repayments and discounting them to present value using the rate on a similar non-convertible bond. The difference between the cash proceeds and the liability component on the issue date is classified as equity.

The liability component is normally much larger than the equity component. As such, the issue of the bond is likely to make the gearing ratio deteriorate, increasing investors' perception of risk. This is because liabilities necessitate mandatory repayments, whereas equity does not.

If the convertible bond is issued then an annual Interest expense will be charged to profit or loss. This interest is calculated by applying the effective rate of interest to the liability component. Interest expenses are charged to the statement of profit or loss and so will reduce profits and basic earnings per share. However, whilst in issue, the convertible bonds have no impact on the number of shares used in the basic earnings per share calculation.

Most convertible bonds are dilutive instruments. This is because the entity has a commitment to issue ordinary shares in the future. The maximum number of shares that Verge may issue to redeem the convertible bonds should be included in the diluted earnings per share calculation. Moreover, the earnings figure used in the calculation should be increased by the current year interest on the bond because this will not be charged after redemption.

The disclosure of diluted earnings per share warns current and potential investors that earnings per share will fall when the convertible bond is redeemed. If investors are concerned about the potential drop, and the impact this may have on their investment returns, then they may decide to invest in other companies.

Marking scheme

			Marks
(a)	(i)	Segment reporting – 1 mark per point	7
	(ii)	Revenue explanation and calculation – 1 mark per point	7
(b)		Finance and impact on financial statements	9
		Professional marks	2
Total			**25**

58 ARON

Key answer tips

This question tests financial instruments. This is a topic that students struggle with so make sure you have thoroughly studied Chapter 12 in the Study Text. Remember that marks are awarded for stating the relevant principles from the relevant accounting standards. Even if you struggle with the calculations for the convertible bond, you would still score solid marks for describing the correct accounting treatment.

(a) Convertible bond

Some financial instruments have both a liability and an equity component. In this case, IAS 32 *Financial Instruments: Presentation* requires that the component parts be accounted for and presented separately according to their substance. The split is made on the issue date.

A convertible bond contains two components:

- a financial liability – the issuer's contractual obligation to pay cash in the form of interest or capital
- an equity instrument – the contract to issue a fixed number of equity shares.

The liability component will be determined by discounting the future cash flows. The discount rate used will be 9%, which is the market rate for similar bonds without the conversion right. The difference between cash received and the liability component is the value of the equity.

	$m
Present value of cash flows	
Year 1 (31 May 20X7) ($100m × 6%) ÷ 1.09	5.50
Year 2 (31 May 20X8) ($100m × 6%) ÷ 1.09^2	5.05
Year 3 (31 May 20X9) ($100m + ($100m × 6%)) ÷ 1.09^3	81.85
Total liability component	92.40
Total equity element	7.60
Proceeds of issue	100.0

The entries required to account for this are:

Dr Cash	$100m
Cr Liability	$92.40m
Cr Equity	$7.60m

The issue cost will have to be allocated between the liability and equity. The entries required are:

Dr Liability	$0.92m
Dr Equity	$0.08m
Cr Cash	$1.00m

After posting the above entries, the liability and equity would have carrying amounts as follows:

	$m	$m
	Liability	**Equity**
Proceeds	92.40	7.60
Issue cost	(0.92)	(0.08)
	–––––	–––––
	91.48	7.52
	–––––	–––––

The equity of $7.52 million will not be re-measured.

The liability component of $91.48 million would be measured at amortised cost. This means that interest is charged at the effective rate of 9.38%. The cash payments reduce the liability.

1 June X6	**Interest (9.38%)**	**Cash paid (6% × $100m)**	**31 May X7**
$m	$m	$m	$m
91.48	8.58	(6.0)	94.06

The finance cost in profit or loss will be $8.58 million. The liability will have a carrying amount on 31 May 20X7 of $94.06 million.

(b) Shares in Smart

Aron has to determine if the transfer of shares in Smart qualifies for derecognition. If substantially all the risks and rewards have been transferred, the asset is derecognised. If substantially all the risks and rewards have been retained, the asset is not derecognised. In this case the transfer of shares in Smart qualifies for derecognition as Aron no longer retains any risks and rewards of ownership.

Aron has obtained a new financial asset which is the shares in Given. Financial assets are initially recognised at fair value. The shares in Given should therefore be initially recognised at $5.5 million. If not held for trading, a designation could be made upon initial recognition to account for this new financial asset at fair value through other comprehensive income.

A profit on disposal of $0.5 million will be recorded in the statement of profit or loss. This is the difference between the initial carrying amount of the Shares in Given and the carrying amount of the shares in Smart that have been derecognised.

The entries required are:

Dr Financial asset (shares in Given)	$5.5m
Cr Financial asset (shares in Smart)	$5.0m
Cr Profit on disposal	$0.5m

Tutorial note

For investments in shares that are measured FVOCI, remeasurements to fair value are recorded in other comprehensive income. This includes remeasurements to fair value immediately prior to disposal. However, the fair value of the shares received in this transaction exceeds the fair value of the shares disposed of. This excess fair value is therefore recognised in profit or loss rather than in other comprehensive income.

In addition, Aron may choose to make a transfer within equity of the cumulative gain recognised up to the disposal date of $400,000.

(c) Investment in bonds

Financial assets are initially measured at fair value, so the investment in the bond will be initially recognised at $10 million.

The entity's business model involves both holding debt instruments to collect their contractual cash flows and also selling the assets. As a debt instrument, it would appear that the contractual terms of the asset comprise the repayment of the principal and interest on the principal amount outstanding. Therefore, the asset should be measured at fair value through other comprehensive income.

Interest income should be recognised in profit or loss using the effective rate of interest. At the reporting date, the asset should be remeasured to fair value with the gain or loss recognised in other comprehensive income. These gains or losses will be recycled to profit or loss if the asset is disposed of.

Interest income of $1.5 million (W1) should be recognised in profit or loss.

Fair value is defined by IFRS 13 *Fair Value Measurement* as the price paid when an asset is sold, or a liability transferred, in an orderly transaction between market participants at the measurement date. IFRS 13 requires entities to prioritise the use of level 1 inputs when measuring fair value, which are defined as quoted prices for identical assets or liabilities in an active market. The quoted price of $9 million appears to be a level 1 input so this is the fair value measurement that should be reported in the financial statements.

Remeasuring the asset to its fair value of $9.0 million will lead to a loss of $2.0 million (W1), which is recorded in other comprehensive income.

Loss allowance

IFRS 9 *Financial Instruments* requires a loss allowance to be recognised on investments in debt that are measured at amortised cost or fair value through other comprehensive income.

If credit risk has not increased significantly since initial recognition, the loss allowance should be equal to 12-month expected credit losses. If credit risk has increased significantly, the loss allowance must be equal to lifetime expected credit losses.

The credit risk of Winston's bonds remains low at the reporting date, suggesting that there has not been a significant increase in credit risk. The loss allowance should therefore be equal to the 12-month expected credit losses of $0.2 million.

When the financial asset is measured at fair value though other comprehensive income, the loss allowance is not adjusted against the asset's carrying amount (otherwise the asset will be held below fair value). Therefore, the loss allowance is charged to profit or loss, with the credit entry being recorded in other comprehensive income (essentially, this adjustment reclassifies $0.2 million of the earlier downwards revaluation from other comprehensive income to profit or loss).

Statement of cash flows

The $10 million cash spent on the financial asset will be presented as a cash outflow from investing activities.

The interest received of $0.5 million will be presented as a cash inflow from investing activities.

Working

(W1) Financial asset

1 June X6	Interest (15%)	Cash received	Total	Loss.	31 May X7
$m	$m	$m	$m	$m	$m
10.0	1.5	(0.5)	11.0	(2.0)	9.0

Marking scheme

		Marks
(a)	Convertible bond – 1 mark per point	9
(b)	Share exchange – 1 mark per point	6
(c)	Winston bonds – 1 mark per point	10
Total		**25**

59 KLANCET *Walk in the footsteps of a top tutor*

Key answer tips

Part (a) requires no calculations. To score well, it is important to be able to apply your accounting knowledge to the specific transactions. Do not simply knowledge dump. Instead, state the recognition and measurement rules from the relevant accounting standards before applying them to the scenario. If you struggle to identify which standards are relevant then think about the items involved. What accounting standard is used to account for an investment in shares? What accounting standard is used for purchases when consideration is in the form of shares?

(a) (i) IFRS 8 *Operating Segments*

Tutorial note

Students often neglect IFRS 8 when studying but it is a popular exam topic. Make sure that you are familiar with the definition of an operating segment as well as the rules governing which operating segments must be disclosed.

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

If a function is an integral part of the business, it may be disclosed as a segment even though it may not earn revenue.

According to IFRS 8, an operating segment should be reported if it meets one of the following quantitative thresholds:

1. Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments.
2. The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments which did not report a loss and (ii) the combined reported loss of all operating segments which reported a loss.
3. Its assets are 10% or more of the combined assets of all operating segments.

The research and development laboratories

Tutorial note

Apply the rules to each of the laboratories in turn. Make sure that you reach an explicit conclusion about whether or not they constitute operating segments.

The first laboratory is not an operating segment. This is because:

- The laboratory does not have a separate segment manager and the existence of a segment manager is normally an important factor in determining operating segments.
- The laboratory is responsible to the divisions themselves, which would seem to indicate that it is simply supporting the existing divisions and not a separate segment.
- There does not seem to be any discrete performance information, which is reviewed by the CODM.

The second laboratory is an operating segment. This is because:

- It has a separate segment manager
- It engages in activities which earn revenues and incurs costs
- Its operating results are reviewed by the CODM and discrete information is available for the laboratory's activities.

The second laboratory should be separately disclosed because its revenues make up more than 10% of the revenues of all operating segments.

(ii) Share transactions

Tutorial note

Take your time and think through which accounting standards are relevant to these transactions. Marks will only be given for discussion of the relevant accounting standards.

Sale of patent

The shares received are in the scope of IFRS 9 *Financial Instruments* and are to be initially measured at fair value. Klancet should derecognise the patent which is transferred to Jancy. Any gain or loss on disposal is recorded in the statement of profit or loss.

The shares should be remeasured to fair value at the year end. Fair value changes are recognised in profit or loss, except for those equity investments for which the entity has elected to report value changes in 'other comprehensive income'.

Klancet should not yet recognise any asset relating to the future royalty stream from the potential sales of the drug, because this stream of royalties is contingent upon the successful development of the drug.

Purchase of patent

Klancet has received a patent in exchange for issuing its own shares. This transaction is within the scope of IFRS 2 *Share-based Payment*.

The transaction is with a supplier, rather than an employee, so Klancet should measure the patent purchased at its fair value and make a corresponding entry to equity (share capital). If Klancet cannot estimate reliably the fair value of the patent then it should measure the transaction at the fair value of the equity instruments granted.

(b) (i) Financial instrument

According to IFRS 9 *Financial Instruments* the financial asset should be initially recognised at its fair value of $5 million. Klancet's business model means that the asset will be measured at fair value through other comprehensive income. Interest income should be calculated using the effective rate of interest. Gains and losses on revaluation to fair value are recorded in OCI.

Bfd	**Interest 10%**	**Receipt***	**Subtotal**	**Loss**	**Fair value**
$m	$m	$m	$m	$m	$m
5.0	0.5	(0.2)	5.3	(0.8)	4.5

* = $5m × 4%

Interest income of $0.5 million is recorded in profit or loss. The asset is revalued to its fair value of $4.5 million, with a loss of $0.8 million recorded in OCI. This revaluation loss will be presented as an item that may be reclassified to profit or loss in the future.

(ii) ***Conceptual Framework***

The *Conceptual Framework* defines an asset as a resource of an entity that has the potential to produce economic benefits. The financial instrument meets the definition of an asset because Klancet has a contractual right to receive cash.

According to the *Conceptual Framework*, an element is recognised in the financial statements if recognition provides relevant financial information, and a faithful representation of the underlying transaction. This would seem to be the case because primary users of the financial statements are interested in the future cash flows that an entity will generate, and this financial instrument gives the entity a contractual right to future cash flows. Moreover, the cost of the asset can be measured reliably. As such, recognition of the asset would appear to be in accordance with the *Conceptual Framework*.

The *Conceptual Framework* states that the statement of profit or loss is the primary source of information about an entity's performance. This statement should enable investors to understand the entity's returns for the period, to assess future cash flows, and to assess stewardship of the entity's resources.

When developing or revising standards, the Board notes that it might require an income or expense to be presented in other comprehensive if it results from remeasuring an item to current value and if this means that:

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

Klancet's business model involves holding the asset to maturity in order to collect the contractual cash flows unless a better investment becomes available. It does not intend to trade the asset in the short-term and so fair value gains and losses on the instrument are largely irrelevant when assessing Klancet's performance. Presenting the fair value loss of $0.8 million in other comprehensive income therefore ensures that the statement of profit or loss best presents the entity's economic returns during the period. This is consistent with the *Conceptual Framework*.

The *Conceptual Framework* states that income and expenditure included in other comprehensive income should be reclassified to profit or loss when doing so results in profit or loss providing more relevant information. In accordance with IFRS 9, the gains and losses on Klancet's debt instrument will be reclassified to profit or loss when the asset is derecognised. In this regard, the treatment of the debt instrument is, once again, consistent with the *Conceptual Framework*.

Marking scheme			
			Marks
(a)	(i)	Operating segments – 1 mark per point	8
	(ii)	Share transactions – 1 mark per point	6
(b)	(i)	Financial instrument – 1 mark per point	4
	(ii)	Conceptual Framework – 1 mark per point	7
Total			**25**

60 EMCEE *Walk in the footsteps of a top tutor*

Key answer tips

This question tests a wide variety of standards. Moreover, part (a) (i) requires students to be able to apply those standards to scenarios that they may not have previously considered. This can be difficult at first but you will improve with practice.

(a) (i) Sports teams

Tutorial note

To score well in part (a)(i) it is important to pick up on certain 'trigger' words within the scenario – 'purchasing registrations' suggests that Emcee is buying intangible assets, 'deciding to sell' suggests that assets may need to be classified as 'held for sale', whereas 'player injuries' suggests there could be impairment issues. Many accounting standards can be examined within a single part of the question.

Purchase of player registrations

IAS 38 *Intangible Assets* states that an entity should recognise an intangible asset where it is probable that future economic benefits will flow to the entity and the cost of the asset can be measured reliably.

Tutorial note

If you are unaware of the detail of IAS 38 Intangible Assets, then use your knowledge of the Conceptual Framework instead. The examiner has said that using the Framework to answers questions will score marks.

Therefore, the costs associated with the acquisition of players' registrations should be capitalised at cost. Cost would include transfer fees, league levy fees, agents' fees incurred by the club and other directly attributable costs.

The cost of player registrations would be amortised over the period covered by the player's contract.

Where a playing contract is extended, any costs associated with securing the extension are added to the unamortised balance at the date of the extension and the revised carrying amount is amortised over the remaining revised contract life.

Decisions to sell

Player registrations would be classified as assets held for sale under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* when their carrying amount is expected to be recovered principally through a sale transaction and a sale is considered to be highly probable. To qualify, the registrations should be actively marketed by Emcee, which it appears that they are. It would also appear that management commits itself to a plan to sell the registrations and that the assets are available for immediate sale. IFRS 5 requires that it is unlikely that the plan to sell the registrations will be significantly changed or withdrawn.

If classified as held for sale, the player registrations would be measured at the lower of their carrying amount and fair value less costs to sell.

Gains and losses on disposal of players' registrations would be determined by comparing the fair value of the consideration receivable, net of any transaction costs, with the carrying amount and would be recognised in profit or loss. Where a part of the consideration receivable is contingent on specified performance conditions, this amount is recognised in profit or loss when the conditions are met.

Impairment issues

Tutorial note

The question refers to players who are injured, or who will not play again. This is an indication that the registration rights for these players might be impaired.

IAS 36 *Impairment of Assets* states an asset is impaired if its carrying amount exceeds its recoverable amount. Recoverable amount is the higher of the asset's fair value less costs of disposal, and its value in use.

It will be difficult to determine the value in use of an individual player in isolation as that player cannot generate cash flows on their own (unless in a sale transaction). As such, impairments may need to be performed on the cash generating unit to which the player belongs. This is likely to be the team as a whole.

There may be some circumstances where a player is taken out of the team, such as if they sustain a career threatening injury. If such circumstances arise, the carrying amount of the player should be assessed against the best estimate of the player's fair value less any costs to sell.

Any impairment losses would be charged to profit or loss.

The playing registrations which were disposed of subsequent to the year-end for $25 million would be disclosed as an event after the reporting period.

(ii) Deferred tax assets

Tutorial note

This is a common exam scenario. Use the information in the question to decide whether Emcee will receive probable benefits from its unused tax losses.

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

IAS 12 explains that the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses only to the extent that the entity has sufficient taxable temporary differences or when there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses can be utilised by the entity.

Emcee recognised losses during the previous five years. In order to use the deferred tax asset of $16 million, Emcee would have to recognise a profit of $53.3 million at the existing tax rate of 30%. In comparison, the entity recognised an average loss of $19 million per year during the five previous years.

Tutorial note

Do Emcee's budgets seem accurate and reliable?

Emcee's budgets and assumptions are not convincing other evidence because the entity does not appear to have been capable of making accurate forecasts in the past and there were material differences between the amounts budgeted and realised for the previous two years. Emcee had presented future budgets primarily based on general assumptions about economic improvement indicators, rather than what was expected to influence the future income and therefore enable the use of the deferred tax asset.

Tutorial note

Are Emcee's losses one-off events, or are they likely to recur?

IAS 12 states that in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, a consideration is whether the unused tax losses result from identifiable causes which are unlikely to recur (i.e. one off events). However, Emcee has continued to recognise impairment losses in excess of budget. This places doubts on the likelihood of future profits arising.

Finally, in its financial statements, Emcee disclosed a material uncertainty about its ability to continue as a going concern. This, again, places doubts on the likelihood of future profits and suggests that recognition of a deferred tax asset for unused tax losses would be inappropriate.

In conclusion the liability of $3 million relating to temporary differences can be offset against $3 million of unused tax losses. No further deferred tax asset relating to tax losses should be recognised.

(b) Disclosure and materiality

Tutorial note

There are some fairly common-sense points to be made in part (b) of the question. What problems arise if disclosures are insufficient? What problems arise if there are too many lengthy disclosures?

Importance of optimal level of disclosure

It is important that financial statements are relevant and understandable. Excessive disclosure can obscure relevant information. This makes it harder for users to find the key points about the performance of the business and its prospects for long-term success

Materiality

An item is material if its omission or misstatement will influence the economic decisions of the users of financial statements.

The Board feels that the poor application of materiality contributes to too much irrelevant information in financial statements and not enough relevant information. As such, they have issued a Practice Statement called *Making Materiality Judgements*.

In the Practice Statement, the Board re-iterate that an entity only needs to apply the disclosure requirements in an IFRS Standard if the resulting information is material. When making such decisions, an entity must consider the common information needs of the primary user groups of its financial statements.

When organising disclosure notes, entities should:

- Emphasise material matters
- Ensure material information is not obscured by immaterial information
- Ensure information is entity-specific
- Aim for simplicity and conciseness without omitting material detail
- Ensure formats are appropriate and understandable (e.g. tables, lists, narrative)
- Provide comparable information
- Avoid duplication

Entities may sometimes need to provide additional disclosures, not required by an IFRS Standard, if necessary to help financial statement users understand the financial impact of its transactions during the period.

Marking scheme			
			Marks
(a)	(i)	Player registrations – 1 mark per point	9
	(ii)	Deferred tax assets and losses – 1 mark per point	8
(b)	Disclosure – 1 mark per point		8
Total			**25**

61 GASNATURE *Walk in the footsteps of a top tutor*

Key answer tips

Use the mark allocation to help you plan your timings. Leaving parts of a question un-attempted is one of the main reasons why students fail exams.

Broadly speaking, you will be awarded one mark for every valid point that you make. If you have not written very much then think about whether there are any key principles from the relevant accounting standard that you haven't written down. Or, alternatively, try and use the *Conceptual Framework* to help you to develop your answer.

As always, thoroughly debrief the model answer and learn from your mistakes. Write down the things you did not know as this will help you to remember them for next time.

(a) (i) Joint arrangements

Tutorial note

In exam questions watch out for scenarios where decision making requires 'unanimous' consent of the parties that share control. This is usually an indication of joint control, suggesting that there is a joint arrangement.

Joint arrangements take two forms: joint operations or joint ventures. Make sure that you are clear on the difference between the two.

A joint arrangement occurs where two or more parties have joint control. Joint control exists when decisions about the relevant activities require the unanimous consent of the parties sharing control.

The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement. A joint arrangement which is not structured through a separate vehicle is normally a joint operation. A joint operator accounts for the assets, liabilities, revenues and expenses relating to its involvement in a joint operation.

The arrangement with Gogas is a joint arrangement, because decisions regarding the platform require unanimous agreement of both parties. The joint arrangement with Gogas should be classified as a joint operation because there is no separate vehicle involved. Gasnature should recognise 55% of the asset's cost as property, plant and equipment.

Dismantling

Under IAS 16 *Property, Plant and Equipment* (PPE), the cost of an item of property, plant and equipment must include the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* stipulates how to measure decommissioning and restoration costs and similar liabilities. Where the effect of the time value of money is material, the amount of a provision should be the present value of the expected expenditure required to settle the obligation.

Tutorial note

In their financial statements, joint operators recognise their interest in the assets and liabilities of the joint operation.

Thus Gasnature should account for 55% of the present value of the estimated decommissioning costs. Gasnature will include this in PPE and will also recognise a provision for the same amount.

Because Gasnature is a joint operator, there is also a contingent liability for 45% of the decommissioning costs as there is a potential obligation if some uncertain future event occurs (such as if Gogas goes into liquidation and cannot fund the decommissioning costs). Therefore Gasnature should disclose a contingent liability to the extent that it is potentially liable for Gogas's share of the decommissioning costs.

(ii) Financial instruments

Tutorial note

The answer below uses a lot of technical detail from IFRS 9 Financial Instruments. However, you could reach the same conclusion by using simple accounting principles. Gasnature is buying gas to use in its business – it is therefore a purchase contract.

IFRS 9 *Financial Instruments* applies to contracts to buy or sell a non-financial item that are settled net in cash Such contracts are accounted for as derivatives.

However, contracts which are for an entity's 'own use' of a non-financial asset are exempt from the requirements of IFRS 9.

There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash. These include:

- when the terms of the contract permit either party to settle it net in cash
- when the entity has a practice of settling similar contracts net in cash
- when the entity has a practice of taking delivery of the non-financial asset and selling it in the short-term to generate a profit
- when the non-financial item is readily convertible to cash.

It could be argued that the contract is net settled because the penalty mechanism requires Agas to compensate Gasnature at the current prevailing market price. Further, if natural gas is readily convertible into cash in the location where the delivery takes place, the contract could be considered net settled.

However, the contract will probably still qualify as 'own use' as long as it has been entered into and continues to be held for Gasnature's usage requirements. This means that it falls outside IFRS 9 and should be treated as an executory contract. The gas will be recorded at cost on the purchase date.

(b) Accounting policy choices

Tutorial note

Take time to think about the choices allowed by each standard. This is your gateway into the rest of the question.

IAS 16 *Property, Plant and Equipment*

After initial recognition, IAS 16 allows property, plant and equipment (PPE) to be measured using either:

- the cost model – cost less accumulated depreciation and impairment losses
- the revaluation model – fair value less accumulated depreciation and impairment losses.

Tutorial note

*First of all think about the impact on the statement of profit or loss. Remember that revaluation gains on property, plant and equipment are **not** recorded in the statement of profit or loss.*

Assuming that property prices are increasing, an entity that revalues its PPE to fair value will record lower profits than one that uses the cost model. Although the gains arising from the revaluation of PPE are recognised outside of profit, in other comprehensive income, the depreciation charge on the revalued asset will be higher than if the cost model was used. As such, using the revaluation model may have a detrimental impact on stakeholders' assessment of an entity's financial performance. Moreover, the higher asset value recorded in the statement of financial position under the revaluation model might also make the entity look less efficient than one which uses the cost model.

Tutorial note

Think about the impact on the statement of financial position.

However, on the positive side revaluation gains will increase equity which will improve the gearing ratio. This may make the entity look like a less risky investment. Moreover, some stakeholders may place importance on an entity's asset base, as this could be used as security for obtaining new finance. Thus, a higher PPE value in the statement of financial position could be viewed positively.

Another thing to note is that the revaluation model will make the asset position of an entity more volatile than an entity that uses the cost model. Volatility can increase the perception of risk. However, the statement of profit or loss will be much less volatile than the statement of financial position because revaluation gains are recorded in other comprehensive income.

It should be noted that entities using the revaluation model for PPE are required to disclose the carrying amounts that would be recognised if the cost model had been used. Such disclosures enable better comparison with entities that account for PPE using different measurement models.

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*

Tutorial note

Your answer does not need to be as detailed as the one presented below.

With regards to asset related grants, two methods of presentation are allowed in the statement of financial position:

- recognise the grant as deferred income and release to profit or loss over the useful life of the asset
- deduct the grant from the carrying amount of the asset and then depreciate the asset over its useful life.

The overall net assets and profit of an entity will not be affected by this choice. However, it could still have an impact on an investor's analysis of the financial statements.

An entity that uses the deferred income method to present asset-related grants will report higher non-current asset assets and higher liabilities than an entity that uses the 'netting off' method.

Reporting a higher level of liabilities may have a detrimental impact on certain ratios, such as the current ratio. More generally, higher liabilities may increase the perception of financial risk, potentially deterring investment.

Reporting higher levels of non-current assets could be viewed positively (as a sign of a strong asset base), or negatively (it may make the entity look less efficient at generating its profit).

With regards to income related grants, two methods of presentation are allowed in the statement of profit or loss:

- present the grant as 'other income'
- present the grant as a reduction in the related expense.

The overall profit of an entity will not be affected by this choice. However, it could still have an impact when analysing financial statements. For instance, an entity that presents grant income by reducing its expenses may be perceived as having better cost control and as operating with greater efficiency than an entity that records its grants within 'other income'.

Cash flows

Accounting policy choices have no impact on the operating, investing or financing cash flows reported in the statement of cash flows.

Marking scheme

				Marks
(a)	(i)	Joint operation – 1 mark per point		7
	(ii)	Gas contract – 1 mark per point		6
(b)	Accounting choices – 1 mark per point			10
	Professional			2
Total				**25**

62 EVOLVE *Walk in the footsteps of a top tutor*

Key answer tips

This question tests core accounting standards in quite unusual scenarios. As such, good application skills are required to score well. Make sure that you get the easiest marks by stating your knowledge of the principles from each relevant accounting standard. Many students leave parts of these questions blank – there is no negative marking so you might as well give it your best attempt!

(a) (i) Non-current assets held for sale

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* says that an asset should be held for sale if its carrying amount will be recovered primarily through a sale and the sale is highly probable to occur.

IFRS 5 does not require the existence of a binding sales agreement in order to classify a non-current asset as held for sale but only a high probability of its occurrence. IFRS 5 states that the appropriate level of management must be committed to a plan to sell the asset for the sale to be probable. Evolve's acceptance of a binding offer in August 20X6 and the publication of this information thus indicated a high probability of sale. Despite the uncertainties surrounding the sale, the transaction remained highly probable at 31 August 20X6.

Other criteria which indicate that the non-current assets should be shown as held for sale include the fact that a buyer for the non-current assets has been found, the sale occurred within 12 months of classification as held for sale, the asset was actively marketed for sale at a price which has been accepted. Despite the uncertainties at 31 August 20X6, events after the reporting period indicate that the contract was not significantly changed or withdrawn. The fact that the information regarding the uncertainties was not publicly disclosed is irrelevant.

Evolve cannot apply IFRS 5 measurement criteria without classifying the item as held for sale in its statement of financial position particularly as impairment may arise when using such criteria.

Thus as the non-current assets met the criteria to be classified as held for sale, they should have been measured and presented as such in the financial statements. Assets classified as held for sale are presented separately within current assets on the face of the statement of financial position.

(ii) Business combinations

IFRS 3 *Business Combinations* must be applied when accounting for business combinations, but does not apply where the acquisition is not of a business. In this case, the acquisition was essentially that of an asset and therefore the measurement requirements of IFRS 3 would not apply.

Investment property

IAS 40 *Investment Property* states that the cost of an investment property comprises its purchase price and any directly attributable expenditure, such as professional fees for legal services. Hence if Evolve wishes to use the cost basis for accounting for the investment property, the potential gain should not have been recorded in profit or loss or added to the cost of the asset.

The specific fiscal treatment and the tax to be paid were not linked to bringing the asset to the condition necessary for its operations, as the asset would have been operational without the tax. As such, the tax is a cost linked to the activity of Evolve and should be accounted for as an expense in accordance with IAS 12 *Income Taxes* and included in profit or loss for the period.

(b) Materiality

Definition

An item is material if its omission or misstatement might influence the economic decisions of the users of the financial statements.

When an entity is assessing materiality, it is considering whether information is relevant to the readers of its own financial statements – in other words, materiality is entity specific. An entity should assume that the users of its financial statements have a reasonable knowledge of business and accounting

The materiality Practice Statement emphasises that materiality judgements are not just quantitative – transactions that trigger non-compliance with laws, or which impact future operations, may affect user decisions even if the monetary amounts involved are small.

Importance of materiality to financial reporting

The purpose of financial reporting is to provide information that will help investors, lenders and other creditors to make economic decisions about providing an entity with resources.

It is important that management consider materiality throughout the process of preparing financial statements. This should ensure that relevant information is not omitted or misstated. The Practice Statement details a four step process:

- Identify information that might be material
- Assess whether that information is material
- Organise the information in draft financial statements
- Review the draft financial statements.

Management should produce financial statements that are free from error. However the impact of certain transactions might be omitted or simplified as long as the resulting errors are immaterial. The materiality Practice Statement recognises that simplified accounting procedures, such as writing off all capital expenditure below $1,000 to profit or loss, can greatly reduce the burden of financial reporting without causing material misstatements.

The concept of materiality does not just help to determine whether transactions are recognised in the financial statements, but also how they are presented. Management may decide to present some material transactions as separate line items in its financial statements, whereas the effects of other immaterial transactions might be aggregated. The Practice Statement emphasises the importance of these decisions: too much detail can obscure important information, whereas over-aggregation leads to a loss of relevant detail.

Materiality assessments also impact disclosure notes. Guidance in this area is important because financial statements have become increasingly cluttered in recent years as the disclosure requirements in IFRS Standards have expanded. However, as IAS 1 *Presentation of Financial Statements* states, an entity need not provide a specific disclosure required by an IFRS Standard if the information is immaterial. The Practice Statement emphasises that the common information needs of primary user groups should always be considered and that the disclosure requirements in IFRS Standards should not be treated as a simple checklist.

Marking scheme			
			Marks
(a)	(i)	Assets held for sale – 1 mark per point	7
	(ii)	Investment property – 1 mark per point	6
(b)		Materiality – 1 mark per point	10
		Professional marks	2
Total			**25**

63 ARTWRIGHT

Key answer tips

This question tests hedge accounting, which is a topic that students struggle with. The transactions in part (b) are relatively simple. If you struggle, it is important that you revisit the Study Text.

(a) Intangible assets

IAS *38 Intangible Assets* requires an entity to recognise an intangible asset 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.

This requirement applies whether an intangible asset is acquired externally or generated internally.

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. The price an entity pays to acquire an intangible asset reflects expectations about the probability that the expected future economic benefits from the asset will flow to the entity. This means that the effect of probability is reflected in the cost of the asset and so the probability recognition criterion is always considered to be satisfied for intangible assets that are acquired separately or in a business combination.

In this case, Artwright should recognise an intangible asset for the use of Jomaster's technology. The right should be measured at its cost of $4 million. The intangible asset should be amortised from the date it is available for use. The technology is available for use when the manufacturing of the compound begins. At the end of each reporting period, Artwright is required to assess whether there is any indication that the asset may be impaired.

Due to the nature of intangible assets, subsequent expenditure will rarely meet the criteria for being recognised in the carrying amount of an asset. Thus Artwright continues to expense its own internal development expenditure until the criteria for capitalisation are met and economic benefits are expected to flow to the entity from the capitalised asset. When the drug is sold, the royalty payments are presented in profit or loss.

Business combinations

IFRS 10 *Consolidated Financial Statements* says that: 'An investor controls an investee when the investor 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'. Therefore it appears that Artwright will control Conew.

Any transaction in which an entity obtains control of one or more businesses qualifies as a business combination and is subject to the measurement and recognition requirements of IFRS 3 *Business Combinations*.

IFRS 3 defines a 'business' as an integrated set of activities and assets that is capable of being conducted and managed to produce returns. A business consists of inputs and processes applied to those inputs which have the ability to create outputs. Processes are included in the acquired group when intellectual property (IP) is accompanied by other resources such as assets or employees or other elements such as protocols and plans which will further help develop the IP to the next phase.

Conew does not meet the definition of a business. It has only one input, and no processes. As such, its inputs and processes are not capable of producing a return. This means that the acquisition of an interest in Conew should be accounted for as an asset acquisition in accordance with IAS 38 *Intangible Assets*.

(b) Hedge effectiveness

If an entity chooses to hedge account then it must assess at inception and at each reporting date whether the hedge effectiveness criteria have been met.

These criteria are as follows:

- **'There is an economic relationship between the hedged item and the hedging instrument**
- **The effect of credit risk does not dominate the value changes that arise from that relationship**
- **The hedged ratio should be the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses.'**

(IFRS 9, para 6.4.1)

IFRS 9 *Financial Instruments* says that the assessment of effectiveness must be forwards-looking.

Derivatives

All derivatives have to be initially recognised at fair value, i.e. at the consideration given or received at inception of the contract. Derivatives A and C appear to have no purchase price, so are initially recognised at nil. Derivative B will be initially recognised at its fair value of $1m.

Derivative A: Artwright has entered into this derivative for speculative purposes. IFRS 9 requires that all derivatives not designated as part of a hedge accounting arrangement are accounted for at fair value through profit or loss. The loss of $20 million that has been incurred has to be immediately recognised profit or loss.

Dr Profit or loss	$20m
Cr Derivative	$20m

Derivative B: If a fair value hedge is effective, then the movement in the fair value of the item and the instrument since the inception of the hedge are normally recognised in profit or loss. However, if the hedged item is an investment in shares that has been designated to be measured at fair value through other comprehensive income (FVOCI), then the fair value movement on the hedged item and the hedging instrument are recognised in other comprehensive income.

The hedged item is an investment of shares designated to be measured at FVOCI. Therefore, the following entries are required at the reporting date:

Dr Financial asset	$8.5m
Cr Other comprehensive income	$8.5m
Dr Other comprehensive income	$10m
Cr Derivative	$10m

Derivative C: If a cash flow hedge is effective, then the movement in the fair value of the instrument is accounted for through other comprehensive income. However, if the movement on the instrument exceeds the movement on the item, then the excess is recognised in profit or loss.

The following entry is required:

Dr Derivative	$25m
Cr Other comprehensive income	$24m
Cr Profit or loss	$1m

When the raw materials are purchased, the gains recognised in other comprehensive income can be reclassified against the carrying amount of the inventory.

(c) Overseas loan

Tutorial note

There are two issues implicit in part (c): how to account for the loan, and how to translate the figures from dinars into dollars. Make sure that you address both of these issues.

The loan is a financial liability because it contains a contractual obligation to transfer cash. In accordance with IFRS 9 *Financial Instruments*, most financial liabilities are measured at amortised cost. Liabilities at amortised cost should be initially recognised at fair value less transaction costs. The finance cost is calculated using the effective rate of interest and charged to profit or loss.

This loan is denominated in an overseas currency and so must be translated using the rules in IAS 21 *The Effects of Changes in Foreign Exchange Rates*. The overseas loan should initially be translated into the functional currency using the historic (spot) rate. The finance cost is translated at the average rate because it approximates to the actual rate. The cash payment should be translated at the historic (spot) rate (which, because the payment occurs at the reporting date, is the year-end rate). A loan is a monetary liability so is retranslated at the reporting date using the closing rate. Any exchange gain or loss is recognised in profit or loss.

Tutorial note

Complete the amortised cost working in dinars, and then translate each figure into dollars using the appropriate exchange rate.

	Dm	Rate	$m
1 May 20X3	5.0	5	1.000
Finance cost (8%)	0.4	5.6	0.071
Payment	(0.4)	6	(0.067)
Foreign exchange gain (bal. fig.)			(0.171)
30 April 20X4	5.0	6	0.833

The loan is initially recorded at $1 million. The finance cost recorded in the statement of profit or loss is $0.071 million, whilst the cash payment is recorded at $0.067 million. A foreign exchange gain of $0.171 million is recorded in the statement of profit or loss. The liability at the reporting date has a carrying amount of $0.833 million.

Marking scheme

		Marks
(a)	Intangibles and business combinations – 1 mark per point	8
(b)	Derivatives and hedge accounting – 1 mark per point	9
(b)	Overseas financial liability – 1 mark per point	8
Total		**25**

64 LUCKY DAIRY

Key answer tips

Part (a) (i) of this question tests IAS 41 *Agriculture*. This is a relatively simple accounting standard, albeit one that is not examined frequently. As such, you may lack familiarity with the core principles of the standard.

Part (b) examines integrated reporting. This is an important area of the syllabus so do not neglect it.

(a) (i) Biological assets

According to IAS 41 *Agriculture* a biological asset, such as a dairy cow, is initially measured at fair value less costs to sell. It should be remeasured at each reporting date to its fair value less estimated costs to sell. Gains or losses on remeasurement are recorded in the statement of profit or loss.

As at 31 May 20X1, the herd would have been carried in the statement of financial position at \$3.5 million. The heifers purchased in the current year should have been recognised at \$1.15 million. At year end, the herd is revalued to its fair value less costs to sell of \$5.58 million. A revaluation gain of \$0.93 million is recognised in profit or loss (W1).

(W1) Biological assets

	Fair value less costs to sell
	\$m
Carrying amount at 31 May 20X1 (70,000 × \$50)	3.50
Purchase (25,000 × \$46)	1.15
Fair value gain (bal. fig.)	0.93
	–––
Carrying amount at 31 May 20X2 (70,000 × 60) + (25,000 × \$55)	5.58 –––

(ii) Financial assets

According to IFRS 9 *Financial Instruments*, a loss allowance should be recognised on financial assets that are debt instruments and which are measured at amortised cost or fair value through other comprehensive income.

If the credit risk of a financial asset has not increased significantly since inception, the loss allowance should equal 12-month expected credit losses. If the credit risk of a financial asset has increased significantly since inception, the loss allowance should equal lifetime expected credit losses. An entity must use reasonable forward-looking information when assessing the level of credit risk.

The bonds had a low credit risk at inception. It would seem that credit risk has increased significantly since inception. This is because of the following:

- The financial performance and cash generation of Jags have been poor and this will have impaired its ability to service its financing obligations.
- The entity was close to breaching loan covenants at year end. A breach of covenants would potentially make loans repayable, thus having a detrimental impact on cash flow.
- The decreased bond price appears to be entity specific and therefore reflective of market concerns about Jags and its credit risk
- External agencies are reviewing the credit rating of Jags, suggesting that credit risk has increased since the publication of its latest financial results.

Due to the increase in credit risk, the loss allowance should be equal to lifetime expected credit losses. Increases or decreases in the allowance will be charged to profit or loss.

(b) Statements of cash flows

Statements of cash flows provide valuable information to stakeholders:

- Cash flows are objective and verifiable and so are more easily understood than profits. In contrast, profits can be manipulated through the use of judgement or choice of a particular accounting policy.
- Cash generated from operations is a useful indication of the quality of the profits generated by a business. Good quality profits will generate cash and increase the financial adaptability of an entity.
- Cash flow information has some predictive value. It may assist stakeholders in making judgements on the amount, timing and degree of certainty on future cash flows.

However, the adjustment of non-cash flow items within operating activities is complex and may not be easily understood. Moreover, the classification of cash flows can be manipulated between operating, investing and financing activities. As such, it is only through an analysis of the statement of financial position, statement of comprehensive income and notes, together with cash flow, that a comprehensive understanding of the entity's position and performance can develop.

Integrated reporting

It is true that International Financial Reporting Standards are extensive and their required disclosures very comprehensive. This has led to criticism that the most relevant information can become obscured by immaterial disclosures. An integrated report would increase disclosure as well as imposing additional time and cost constraints on the reporting entity.

However, integrated reporting will provide stakeholders with valuable information which would not be immediately accessible from an entity's financial statements.

Financial statements are based on historical information and may lack predictive value. They are essential in corporate reporting, particularly for compliance purposes but do not provide meaningful information regarding business value. The primary purpose of an integrated report is to explain to providers of capital how the organisation generates value over time.

This is summarised through an examination of the key activities and outputs of the organisation whether they be financial, manufactured, intellectual, human, social or natural.

An integrated report seeks to examine the external environment which the entity operates within and to provide an insight into the entity's resources and relationships to generate value. It is principles based and should be driven by materiality, including how and to what extent the entity understands and responds to the needs of its stakeholders. This would include an analysis of how the entity has performed within its business environment, together with a description of prospects and challenges for the future. It is this strategic direction which is lacking from a traditional set of financial statements and will be invaluable to stakeholders to make a more informed assessment of the organisation and its prospects.

Marking scheme			
			Marks
(a)	(i)	Biological assets – 1 mark per point	6
	(ii)	Financial assets – 1 mark per point	8
(b)	Cash flows and integrated reports – 1 mark per point		9
	Professional marks		2
Total			**25**

UK GAAP FOCUS

65 STEM (SEP/DEC 2021)

Key answer tips

Well prepared candidates who have studied the differences between FRS 102, should have fared well with the UK aspects of this question. Part (a) tests the differences between FRS 102 and IFRS 3, an area with many clear differences e.g. the treatment of transaction costs, amortisation vs impairment.

Part (b) covers joint ventures, which may have proved a little more taxing. The UK treatment of joint ventures is much the same as the international version so plenty of marks for the basic concepts would be available. The only differences caused by the application of FRS 102 are some of the terms used (FRS 102 uses 'joint venture' to cover jointly controlled operations, jointly controlled assets and jointly controlled entities, whereas IAS 28 uses the terms 'joint arrangement' to cover all of these options, and a 'joint venture' becomes solely a jointly controlled entity) and the treatment of the discounted purchase as negative goodwill within the statement of financial position (IFRS takes this to profit as a gain on a bargain purchase).

(a) FRS 102 vs IFRS 3

The key differences between IFRS 3 *Business Combinations* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* are as follows:

- According to FRS 102, transaction costs are included in the cost of acquisition whereas with IFRS 3, all costs of acquisition are written off as incurred.
- Contingent consideration is also included as part of the acquisition cost if it is probable that the amount will be paid and it can be measured reliably. In accordance with IFRS 3, contingent consideration must be measured at fair value at the time of the business combination and is taken into account in the determination of goodwill.
- FRS 102 states that where control is achieved through a series of transactions, the acquisition cost is the total of the fair values of the assets given, liabilities assumed and equity instruments issued at the date of each transaction. With IFRS 3, the acquirer remeasures any previously held interest at fair value and takes this amount into account in the determination of goodwill. Any resultant gain or loss is recognised in profit or loss or other comprehensive income as appropriate.
- FRS 102 requires negative goodwill to be recognised in profit or loss in the periods expected to benefit from its existence whereas IFRS 3 states that the resulting gain is a bargain purchase which is recognised immediately in profit or loss.
- FRS 102 utilises only the proportionate share method for non-controlling interest and does not allow the fair value method as an option.
- IFRS 3 includes more detailed rules than FRS 102 on fair valuation.

- FRS 102 requires entities to recognise fewer intangible assets acquired in a business combination separately from goodwill. Entities may choose to separately recognise additional intangible assets acquired in a business combination if this provides useful information to the entity and the users of its financial statements.
- FRS 102 requires the acquirer to measure goodwill acquired in a business combination at cost less accumulated amortisation and accumulated impairment losses. Goodwill is considered to have a finite useful life and is amortised on a systematic basis over its life. If, in exceptional cases, an entity is unable to make a reliable estimate of the useful life of goodwill, the life shall not exceed 10 years. With IFRS 3 the goodwill impairment assessment is made each year.

(b) Emphasis Co

FRS 102 defines joint control as the contractually agreed sharing of control over an economic activity, and it exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control. Further, a joint venture is a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control. Joint ventures can take the form of jointly controlled operations, jointly controlled assets, or jointly controlled entities. A jointly controlled entity is a joint venture which involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other entities, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity.

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

FRS 102 states that a venturer which is a parent shall, in its consolidated financial statements, account for all of its investments in jointly controlled entities using the equity method. Therefore, Stem Co should account for any difference, 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 in accordance with the business combinations regulations of FRS 102, that is, it is accounted for like goodwill. Where an investment is less than their share of the fair value of the identifiable net assets acquired, such a transaction results in a gain to the investor and is referred to as negative goodwill.

However, negative goodwill is rare. Therefore, before recognising such a gain, Stem Co should:

(a) Reassess the identification and measurement of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination.

(b) Recognise and separately disclose the resulting excess on the face of the statement of financial position on the acquisition date, immediately below goodwill, and followed by a subtotal of the net amount of goodwill and the excess.

(c) Recognise subsequently the excess up to the fair value of non-monetary assets acquired in profit or loss in the periods in which the non-monetary assets are recovered. Any excess exceeding the fair value of non-monetary assets acquired should be recognised in profit or loss in the periods expected to be benefited.

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 value of the net assets contributed by the investors was $310,000 but the fair value of the net assets contributed was $470,000. Therefore, Stem Co's share of the fair value of the identifiable assets of Emphasis Co is 40% of $470,000, 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 negative goodwill of $38,000 ($188,000-$150,000) which is recognised in profit or loss in the periods expected to be benefited.

Dr Investment in Emphasis Co	$188,000
Cr Cash	$150,000
Cr SOFP – negative goodwill (shown just below goodwill)	$38,000

Marking scheme

		Marks
(a)	Discussion of key differences between FRS 102 and IFRS 3:	
	Transaction costs	1
	Contingent consideration	1
	Step acquisition	1
	Bargain purchase	1
	Proportionate method v fair value	1
	Fair value	1
	Intangibles/goodwill	1
		7
(b)	Discussion and application of key principles of joint venture accounting with well-argued conclusion	5
	Discussion of negative goodwill	2
	Accounting of negative goodwill	1
		8
Total		**15**

66 SITKA (MAR/JUN 2021)

Key answer tips

This UK variant question is pretty tough, testing areas that would need detailed knowledge of the UK GAAP content (chapter 24 in your study text). The differences you need to be aware of relate to the **recognition criteria** applied to an intangible asset, the treatment of group investments in separate financial statements and fair values.

For part (c) a comparison of the FRS 102 treatment of fair values versus the international equivalent (IFRS 13) is required. Here, at least, some marks will be given for your core IFRS knowledge. Therefore, even if your UK preparation is found wanting, make sure you discuss the IFRS treatment (and take an educated guess as to what the UK difference may be).

This question shows how important thorough preparation for the UK variant question is. Any of the differences between FRS 102 and IFRS standards could be tested within the examination.

(a) Cent Co pays fees to Sitka Co to access and use its software. The recognition criteria for an intangible asset in accordance with FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* are identifiability, the probability that the expected future economic benefits will flow to the entity and reliable measurement. 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 measurement criteria but there needs to be an assessment as to whether it is probable that the expected benefits will flow to the entity. FRS 102 states that an entity should assess the probability of expected future economic benefits using reasonable and supportable assumptions which represent management's best estimate of the economic conditions which will exist over the useful life of the asset. Cent Co does not own the rights to the software at any time and cannot run the software on its own hardware. For it to be probable that the expected future economic benefits would flow to the entity, then Cent Co would have to exercise some control over the software. This is not the case.

Thus, Cent Co should not recognise an intangible asset because Cent Co does not control the resource. The contract is not a lease contract 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) FRS 102 requires an entity which prepares separate financial statements to account for investments in subsidiaries, joint ventures and associates either

– at cost less impairment,

– at fair value with changes in fair value recognised in other comprehensive income, or

– at fair value with changes in fair value recognised in profit or loss.

Sitka Co has elected to measure its subsidiary at cost less impairment. 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. In accordance with FRS 102, investments in non-puttable ordinary shares are measured at fair value if the shares are publicly traded or their fair value can otherwise be measured reliably. Any changes in fair value are recognised in profit or loss.

The carrying amount attributable to the investment at the date when Marlett Co ceased to be a subsidiary will be regarded as the cost on initial measurement of the financial asset of (15%/60% of $12m) $3 million and not its fair value of $3·5 million. Where a parent ceases to control a subsidiary, a gain or loss should be recognised in its individual statement of profit or loss, calculated as the difference between:

(i) the proceeds from the disposal and

(ii) the proportion of the carrying amount of the subsidiary's net assets disposed of as at the date of disposal.

Thus, Sitka Co would make a profit of $(10 – (45%/60% x12)) million, i.e. $1 million. Sitka Co should not present any difference in other comprehensive income as it is not permitted in accordance with FRS 102. Conceptually, the difference meets the definition of income or expenses in FRS 102.

(c) FRS 102 states that the fair value is the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

IFRS 13 *Fair Value Measurement* defines fair value as the price which would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. 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. FRS 102 does not directly specify the use of this concept but often refers to fair value being measured with sufficient reliability.

It can be argued that both standards state that 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 ($200 million). The use of the assets in a group does not maximise the fair value of the assets individually but it maximises the fair value of the asset group. 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.

Marking scheme		
		Marks
(a)	Discussion and application of the following to the situation:	
	FRS 102	3
	Service contract	1
		4
(b)	Discussion and application of the following to the situation:	
	Separate financial statements	2
	Financial asset	2
	Carrying amount	2
	Calculation of profit or loss	1
	Principles of OCI	1
		8
(c)	Discussion and application of the following to the situation:	
	FRS 102 definition	1
	IFRS 13 highest and best use	2
	Grouping of fair values	2
		5
Total		**17**

67 CORBEL (SEP/DEC 2020)

Key answer tips

High marks can be obtained on this question by using your knowledge of IFRS Standards and then substituting in any UK GAAP differences – such as the fact that FRS 102 does not have a concept of 'held for sale' and does not permit intangibles to have an indefinite life.

(a) Jengi brand name

FRS 102 states that an entity shall assess at each reporting date whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. If there is no indication of impairment, it is not necessary to estimate the recoverable amount. Thus, the brand need not be tested for impairment.

FRS 102 defines a cash generating unit (CGU) as the smallest identifiable group of assets that includes the asset and generated cash flows that are largely independent of the cash inflows from other assets or other groups of assets. However, brands are typically not a separate CGU under FRS 102 and are not tested for impairment individually.

For the purpose of impairment testing, 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.

(b) Perfume brand names

FRS 102 states that all intangible assets shall be considered to have a finite useful life. Additionally, if, in exceptional cases, an entity is unable to make a reliable estimate of the useful life of an intangible asset, the life shall not exceed 10 years. Thus, under FRS 102, the perfume brands cannot be considered to have an indefinite life.

Corbel Co should consider various factors to determine the brand names' useful life. These will include the extent to which Corbel is prepared to support the brand and the extent to which the brand has long-term potential and has had proven success, such as the Locust perfume.

Perfume is subject to market and fashion trends and so an assessment of how resistant the brands are to change should be made. 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.

The Clara perfume is linked to the popularity of the actor and therefore its useful life is likely to be dependent upon the longevity of the popularity of the actor.

(c) Proposed store closure

There is no separate guidance in FRS 102 for non-current assets held for sale as it does not have a concept that is comparable to IFRS 5 *Non-current assets Held for Sale*, of assets being classified as 'held for sale'.

Under FRS 102, where an entity intends to sell a non-current asset (NCA)in the near future, the asset should continue to be held in property, plant and equipment unless that asset is being transferred to inventory for sale in the ordinary course of the company's business. The asset will be derecognised at the point of sale or disposal and any profit or loss on disposal recognised accordingly.

This is different to IFRS 5 which requires that a non-current asset be reclassified as 'held for sale' if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. Using IFRS 5, the six stores would be accounted for as a discontinued operation as they represent a component of Corbel Co and are a separate geographical area of operations.

Under FRS 102, the approval and announcement of a plan to close the six Italian stores is an indication that the assets attributable to the sale may be impaired. In addition, the six stores would be classified as a 'disposal group' which is a group of assets that an entity intends to dispose of in a single transaction. FRS 102 sets out the disclosure requirements for situations where an entity has a binding sale agreement at the reporting date for a major disposal of assets or a disposal group. As stated above, FRS 102 states that an entity shall assess at each reporting date whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. If there is no indication of impairment, it is not necessary to estimate the recoverable amount.

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. 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 FRS 102, no restructuring provision should be recognised.

(d) Primary store

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 scheme		
		Marks
(a)	Treatment of brand on acquisition	2
	Allocation to CGU	2
		4
(b)	Principles	2
	Application	4
		6
(c)	Contrast with IFRS 5	3
	Application of FRS 102 to scenario	3
		6
(d)	Impairment principles	2
	Impairment of primary store	2
		4
Total		**20**

68 LERIA (MAR 2020)

Key answer tips

Part (a) of this question is relatively straight forward – especially if you have learned the UK GAAP content from Chapter 24 of the Study Text. In part (b) it is important to remember that the accounting treatment under FRS 102 and IFRS Standards for many transactions is the same. Alternative answers with regards to the treatment of the contingent consideration would also be allowable.

(a) Intangible assets

FRS 102 only requires recognition of intangible assets other than goodwill arising on a business combination if they are separable **and** arise from legal or contractual rights. IFRS 3 *Business Combinations* says that intangible assets other than goodwill arising from a business combination are recognised at fair value if they are separable **or** if they arise from legal or contractual rights.

Under FRS 102, all intangible assets are considered to have a finite life. The life should not exceed 10 years where a reliable estimate of the life cannot be made. IAS 38 states that an intangible asset can have an indefinite life where there is no foreseeable limit to the period that the asset will generate cash inflows. Such assets are not amortised.

FRS 102 allows an entity to capitalise development expenditure subject to certain criteria. However, an entity may choose to expense this expenditure as incurred. This policy must be applied consistently. However, IAS 38 does not allow this policy choice as intangible assets arising from the development phase of a project must be capitalised if certain criteria are met.

FRS 102 states that if an intangible asset is acquired free of charge or for nominal consideration by way of a grant, the cost of that intangible asset is its fair value at the date the grant is received or receivable. IAS 38 permits a policy choice between recognising the intangible asset at fair value or at a nominal amount.

(b) Contracts

When a player's contract is signed, management should make an assessment of the likely outcome of performance conditions. Thus, the contingent consideration will be recognised in the players' registration costs if management believes the performance conditions will be met in line with the contractual terms. Periodic reassessments of the potential should be completed. Any 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. The costs associated with an extension 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.

If there is no indication of impairment, under FRS 102 then, it is not necessary to estimate the recoverable amount. However, where a player sustains a career threatening injury and is removed from the playing squad, 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.

It is unlikely that any individual player can be separated from the single cash generating unit (CGU) which will be the playing squad. 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)	Key differences	5
(b)	Performance conditions	5
	Value in use	2
		7
Total		**12**

69 DIGIWIRE (SEP/DEC 2019)

Key answer tips

This is a tricky UK GAAP question. Part (a) tests some relatively small differences between IFRS Standards and FRS 102 that you would only know after thoroughly studying Chapter 24 of the Study Text. Part (c) relies on a knowledge of current issues – a topic that many students neglect. The easiest marks are probably available in part (b) for demonstrating knowledge of the true and fair override and for explaining how this might impact on the usefulness of financial information.

(a) Termination benefits

Where an entity is committed to make payments to employees when it terminates their employment, these payments are categorised as termination benefits. These payments do not carry with them any future economic benefits and are recognised as an expense in profit or loss immediately.

Under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, if a termination is linked to restructuring, an entity must be demonstrably committed to a termination, which is only the case when the entity has a detailed formal plan for the termination and is without realistic possibility of withdrawal from the plan.

IAS 19 *Employee Benefits* has similar rules regarding terminations linked to restructuring, but gives more detailed guidance on the criteria which demonstrate that the entity is committed to the plan. For example, under IAS 19, it should be unlikely that significant changes to the plan will be made. Also, there should be specific detail regarding numbers of employees, type and amount of benefit, location of the termination and the expected completion date.

(b) Amendments to IAS 19

FRS 102 does not require entities to revise the assumptions for the calculation of current service cost and net interest during the accounting period, even if an entity remeasured the net defined benefit liability or asset in the event of a plan amendment, curtailment or settlement. The calculations are based on the actuarial assumptions as at the start of the financial year. However, it seems inappropriate to ignore any updated assumptions when determining current service cost and net interest for the period.

Therefore, an amendment to IAS 19 if adopted by FRS 102 would change the calculation of net interest and current service cost as follows. 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.

If Digiwire Co had applied FRS 102 then the current service cost would have been $108 million (12 months × $9 million). If Digiwire Co applied the revised IAS 19 requirements, the current service cost would be $96 million ((8 months × $9 million) + (4 months × $6 million)). Thus there will be a reduction in the current service cost of $12 million.

Similarly, the net interest component calculated under FRS 102 would be $900,000 (3% × $30 million). In accordance with the revised IAS 19 requirements, the net interest component would be calculated as $1,020,000 (($900,000 × 8/12) + (3.5% × $36m × 4/12)). Therefore, applying revised IAS 19 would increase the net interest component by $120,000 ($1,020,000 – $900,000).

The net effect will be to change the re-measurement component by $11,880,000.

(c) True and fair override

The Companies Act requires that the directors of a company must not approve financial statements unless they are satisfied they give a true and fair view. Where directors and auditors do not believe that a particular accounting policy will give a true and fair view, they are legally required to adopt a more appropriate policy, even if this requires a departure from a particular accounting standard.

The true and fair override is enshrined in FRS 102 and it requires departure from the requirements of a specific accounting standard when compliance would conflict with the objective of financial statements. 'Fair presentation' is where the effects of transactions are represented faithfully so, in effect, there is unlikely to be any substantial difference in practical terms between it and the true and fair concept.

For companies reporting under UK GAAP, FRS 102 and *Companies Act* require that directors make prudent judgements in their consideration of financial statements, particularly where there is uncertainty. Disagreement with a particular standard does not, on its own, provide grounds for departing from it. Where the accounting standards clearly address an issue, but the requirements are insufficient to fully explain the issue, the solution is normally additional disclosure. However, if the financial statements do not represent faithfully the transactions, other events and conditions which they purport to present or could reasonably be expected to represent, then that is where the true and fair override is applied.

Comparability enhances the usefulness of financial information. Thus accounting information would be more useful if it can be compared with similar information from other entities, or from the same entity. Comparability is crucial to improve financial reporting quality but is made more difficult when entities can override accounting standards.

ACCA marking scheme		
		Marks
(a)	FRS 102 vs. IAS 19	3
(b)	Discussion of FRS 102 vs IAS 19 differences	4
	Calculation of impact of differences	4
		8
(c)	True and fair override	3
	Impact on faithful representation and comparability	3
		6
Total		**17**

70 CRYPTO (MAR/JUN 2019)

Key answer tips

If you are studying SBR UK then it is important to thoroughly learn the examinable UK content. This is covered in Chapter 24 of the Study Text. You will find this content easier to learn if you have a solid grasp of the examinable IFRS Standards.

(a) Control

The definition of control in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* is different from the definition in IFRS 10 *Consolidated Financial Statements*.

FRS 102 states that control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. FRS 102 states that control is presumed to exist if an entity owns more than half of the voting rights of another entity. This presumption may be overcome in exceptional circumstances if it can be clearly demonstrated that such ownership does not constitute control.

FRS 102 further states that control also exists when the parent owns half or less of the voting power of an entity but it has:

- power over more than half of the voting rights by virtue of an agreement with other investors
- power to govern the financial and operating policies of the entity under a statute or an agreement
- power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
- power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

Control can also be achieved by having options or convertible instruments which are currently exercisable or by having an agent with the ability to direct the activities for the benefit of the controlling entity. Control can also exist when the parent has the power to exercise, or actually exercises, dominant influence or control over the undertaking or it and the undertaking are managed on a unified basis.

IFRS 10, however, 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.

Joint arrangements

FRS 102 now makes a distinction between jointly controlled entities, jointly controlled assets and jointly controlled operations. Under FRS 102, classification as a jointly controlled entity is driven by whether there is the creation of a separate legal entity. Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control.

In contrast, IFRS 11 *Joint Arrangements* outlines the accounting by entities which jointly control an arrangement and classifies the arrangements differently to FRS 102. Under IFRS 11, the arrangements are classified as either a joint venture (representing a share of net assets and equity accounted) or a joint operation (representing rights to assets and obligations for liabilities, accounted for accordingly).

(b) Joint control

FRS 102 defines joint control as the contractually agreed sharing of control over an economic activity. Joint control exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing 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 FRS 102. After this assessment, an entity must determine whether it has joint control of the arrangement which, in turn, means an assessment as to whether any party can prevent any of the other parties from making unilateral decisions without its consent. 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. Additionally, Crypto does not control Kurran as FRS 102 states that control requires the power to govern the financial and operating policies of an entity so as to obtain benefits from its 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 the shareholders' voting rights and obligations and thus the other shareholders can act together to prevent Crypto from making decisions in its own interest. Crypto does not have joint control as agreement between itself and other board members has to occur for a decision to be made. Therefore, it appears that Kurran is an associate of Crypto.

(c) Translating a foreign operation

FRS 102 sets out one procedure to be followed when translating the results of a foreign subsidiary into the presentation currency of the group:

- all assets and liabilities (whether monetary or non-monetary) for each statement of financial position presented (i.e. including comparatives) are translated at the closing rate at the year-end date
- income and expenses for each statement of comprehensive income (i.e. including comparatives) are translated at exchange rates at the dates of the transactions; and

- all resulting exchange differences are recognised in other comprehensive income and accumulate in equity.

Unlike IAS 21 *The Effects of Changes in Foreign Exchange Rates*, the cumulative exchange differences are not required to be recorded in a separate reserve within equity, although a separate reserve may be used if preferred.

Any accumulated exchange differences on non-wholly owned subsidiaries arising from translation and attributable to non-controlling interests should be allocated to, and recognised as part of, non-controlling interests in the consolidated statement of financial position.

On disposal of the foreign subsidiary, any cumulative exchange differences are not reclassified to profit or loss and simply remain in equity.

ACCA marking scheme		
		Marks
(a)	Control definitions	3
	FRS 102 requirements and IFRS 11 classifications	3
		6
(b)	Control	3
	Power	3
		6
(c)	FRS 102 requirements	2
	Discussion of FRS 102 and IAS 21 and NCI	3
		5
Total		**17**

71 FILL (DEC 2018)

Key answer tips

Students sitting SBR UK might be asked to discuss the accounting treatment of a transaction in accordance with FRS 102. If you know the treatment under IFRS Standards, and you know the differences between IFRS Standards and FRS 102, then you should be able to make a good attempt.

(a) Borrowing costs

Under FRS 102 *The Financial Reporting Standard Applicable in the UK and Republic of Ireland*, an entity **may** adopt a policy of capitalising borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. A qualifying asset is an asset which necessarily takes a substantial period of time to get ready for its intended use. Fill can capitalise the borrowing costs which relate to the licence. However, as the equipment will be used for other construction projects throughout the UK, the borrowing costs relating to it cannot be capitalised.

Impairment

FRS 102 specifies that a recoverable amount need not be determined unless there are indicators of impairment. There is evidence of a decline in forward prices. Short-term market fluctuations may not be impairment indicators if prices are expected to return to higher levels. However, if the decline in prices is for a significant proportion of the remaining expected life of the mine then it is more likely to be an impairment indicator. It appears that forward contract prices for two years out of the four years of the mine's remaining life indicate a reduction in selling prices and so it would appear that the mining assets should be tested for impairment, especially as the entity wishes to sell the mine. Impairment would be recognised if a mine's carrying amount exceeds its recoverable amount.

Decision to sell

As far as the decision to sell the mine is concerned, FRS 102 does not address assets held for sale; the decision to sell an asset is considered an impairment indicator although continuing and discontinued activities must be analysed. FRS 102 states that an internal indicator of impairment occurs when significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to dispose of an asset before the previously expected date. If there is an indication that an asset may be impaired, this may indicate that the entity should review the remaining useful life, the depreciation method or the residual value for the asset.

(b) Business combinations

Under FRS 102, the cost of a business combination includes any costs directly attributable to the business combination, for example, any advisory and legal fees. However, IFRS 3 *Business Combinations* explicitly excludes such costs from the cost of a business combination. Thus, such costs generally form part of goodwill under FRS 102, whereas under IFRS 3, they are recognised as expenses in the period.

If a business combination is acquired in stages, IFRS 3 states that the consideration paid is all measured at the acquisition date fair value in accordance with full IFRS Standards whereas FRS 102 states that the consideration given for each stage is measured at its fair value at the date when the stage was recognised in the financial statements.

Under FRS 102, contingent consideration is included in the cost of a business combination, if its payment is probable and the amount can be measured reliably. IFRS 3 requires the fair value of contingent consideration to be included in the cost of a business combination regardless of whether payment is probable; its fair value is determined by considering the different possible outcomes and estimating the probability of each outcome. Under FRS 102, if the contingent consideration subsequently becomes probable and can be measured reliably, the amount is treated as an adjustment to the cost of the business combination.

Under FRS 102, non-controlling interest (NCI) is measured at its proportionate share of the group carrying amounts of the subsidiary's identifiable net assets. Using this method, goodwill is not included in the carrying amount of non-controlling interest. Under IFRS 3, non-controlling interest is measured using either the fair value method or the proportionate share method. With the fair value method, the NCI's stake in the entity is valued at fair value with the result that all of the entity's goodwill is recognised. The part of the goodwill which is attributable to the equity owned by the NCI is included in the measurement of the non-controlling interest. If the fair value method is used, both goodwill and non-controlling interest are different from those calculated under FRS 102.

Marking scheme		
		Marks
(a)	Borrowing costs	2
	Impairment and decision to sell	5
		7
(b)	Costs	2
	Consideration and stage payments	3
	NCI	3
		8
Total		**15**

72 SKIZER (SEP 2018)

Key answer tips

Students sitting SBR UK might be asked to discuss the accounting treatment of a transaction in accordance with FRS 102. If you know the treatment under IFRS Standards, and you know the differences between IFRS Standards and FRS 102, then you should be able to make a good attempt.

(a) FRS 102 recognition criteria

FRS 102 requires an entity to recognise an intangible asset if:

- it is probable that expected future economic benefits will flow to the entity, and
- the cost of the asset can be measured reliably.

This requirement applies whether an intangible asset is acquired externally or generated internally. 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. The probability recognition criterion is always considered to be satisfied for intangible assets which are acquired separately or in a business combination.

If the recognition criteria are not met, FRS 102 requires the expenditure to be expensed when it is incurred.

Conceptual Framework

According to the *Conceptual Framework,* items are only recognised if they meet the definition of an element. The definition of an asset is '**a present economic resource controlled by an entity as a result of a past event**' (para 4.3).

This does not mean that all items meeting the definition of an element are recognised. An element is only recognised if recognition provides users with useful financial information. In other words recognition must provide:

- relevant information
- a faithful representation of the asset or liability, and resulting income, expenses or equity movements.

Recognition might not provide relevant information if there is uncertainty over the existence of the element or if there is a low probability of an inflow or outflow of economic resources. Recognition of an element might not provide a faithful representation if there is a very high degree of measurement uncertainty.

Consistency

As can be seen, the recognition criteria in the *Conceptual Framework* and FRS 102 are different.

Both FRS 102 and the *Conceptual Framework* attempt to ensure that financial statements provide information that meets the qualitative characteristics of useful information but do this in different ways. FRS 102 uses practical filters of probability and reliability to exclude information that will not be useful. In contrast, the *Conceptual Framework* refers directly to the qualitative characteristics, and provides guidance on how to apply them.

(b) Development projects

Skizer should have assessed whether the recognition criteria in FRS 102 were met at the time the entity capitalised the intangible assets. If the recognition criteria were met, then it was not appropriate to derecognise the intangible assets. According to FRS 102, an intangible asset should be derecognised only on disposal or when no future economic benefits are expected from its use or disposal.

If there were any doubts regarding the recoverability of the intangible asset, then Skizer should have assessed whether the intangible assets would be impaired. Prior to the current year, Skizer was unable to make a reliable estimate of the useful life of the intangible assets. However, FRS 102 states that the life should not exceed 10 years.

Further, the reclassification of intangible assets to research and development costs does not constitute a change in an accounting estimate. Under FRS 102, a change in accounting estimate is an adjustment of the carrying amount of an asset or liability, or related expense, resulting from the assessment of the present status of, and expected future benefits associated with, that asset or liability.

If the directors of Skizer decide that the recognition criteria were not initially met, then Skizer would have to recognise retrospectively a correction of an error.

(c) Differences between UK GAAP and IFRS Standards

Under UK GAAP, an entity may capitalise development expenditure where certain criteria are met. Under IAS 38 *Intangible Assets*, an intangible asset arising from the development phase of an internal project must be capitalised if certain criteria are met.

If an intangible asset is acquired through a business combination and arises from legal or contractual rights, then FRS 102 allows recognition if there is evidence of exchange transactions for similar assets. Under IFRS 3 *Business Combinations*, intangible assets acquired through a business combination are recognised if they are separable, or if they arise from legal or contractual rights.

Under FRS 102, goodwill is amortised over its useful life. If the useful economic life cannot be reliably determined, then the estimate used should not exceed ten years. Under International Financial Reporting Standards, amortisation of goodwill is not permitted. Instead annual impairment testing is required.

Marking scheme		
		Marks
(a)	Recognition criteria – 1 mark per point	6
(b)	Development – 1 mark per point	5
(c)	UK GAAP differences	4
Total		**15**

73 BOBARRA

Key answer tips

Students sitting the UK paper are expected to know Companies Act requirements concerning the preparation of consolidated financial statements. This needs to be learned. However, you would not be expected to reproduce the detail below.

There are not many differences between International Financial Reporting Standards and UK GAAP with regards to related party transactions. There are a couple of marks available for talking about FRS 102 exemptions and whether they apply in this scenario.

(a) Companies Act

The requirements in the Companies Act to prepare group accounts are largely mirrored in FRS 102, which states that consolidated financial statements (group accounts in the Companies Act) are prepared by all parent entities unless one of the following exemptions, which are derived from the Companies Act, applies:

- The parent company is subject to the small companies' regime (see ss.383 to 384 of the Companies Act).

- The parent company is a subsidiary included in a larger group which prepares consolidated financial statements and meets the requirements of ss.400 or 401 of the Companies Act, including:
  - The parent is itself a subsidiary whose immediate parent is established in an EEA state, and whose results are consolidated into the group financial statements of an undertaking established in an EEA state (not necessarily the immediate parent). Companies Act sets out further conditions for this exemption, including that a company, which has any of its securities admitted to trading on a regulated market in an EEA state, is not eligible for this exemption.
  - The parent is itself a subsidiary, its immediate parent is not established in an EEA state, and its results are consolidated into the group accounts of an undertaking (either the same parent or another) drawn up in accordance with the EU Seventh Directive or in an equivalent manner (for example, EU-IFRS accounts). Companies Act sets out further conditions for this exemption, including that a company, which has any of its securities admitted to trading on a regulated market in an EEA state, is not eligible for this exemption.
- All of the parent's subsidiaries are excluded from consolidation under FRS 102.

If an entity is not a parent at the year end, then it is not required to prepare consolidated accounts.

Exclusion of subsidiaries from consolidation

Consolidated financial statements provide information about the group as a single economic entity. They include all subsidiaries of the parent except those excluded on one of the following grounds:

- severe long-term restrictions substantially hinder the exercise of the rights of the parent over the assets or management of the subsidiary. These rights are the rights held by or attributed to the company in the absence of which it would not be the parent company; or
- the subsidiary is held exclusively for resale and has not previously been included in the consolidation.

Companies Act states that a subsidiary may be excluded from consolidation if the necessary information to prepare the group accounts cannot be obtained without disproportionate expense or undue delay. FRS 102, however, states that this does not justify non-consolidation, effectively closing off the statutory option. Subsidiaries are not excluded from consolidation simply because the subsidiary has dissimilar business activities to the rest of the group.

(b) Related parties

The objective of both IAS 24 *Related Party Disclosures* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* as regards related party disclosures is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

Individuals

A person or a close member of that person's family is related to a reporting entity if that person:

- has control or joint control over the reporting entity
- has significant influence over the reporting entity; or
- is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

As regards Bobarra, the finance director is a related party because he controls Bobarra and is a member of the key management personnel. The sales director is also a related party of Bobarra as she is a member of the key management personnel and is a close member (spouse) of the family of the finance director. Their son is a related party of Bobarra as he is a close member (son) of their family. The operations director is also a related party as he is a member of key management personnel and has significant influence (more than 20% of the voting power) over Bobarra.

IAS 24 requires that the disclosure of key management personnel remuneration is broken down into the following categories:

- short-term benefits
- post-employment benefits
- other long-term benefits
- termination benefits
- share-based payments.

FRS 102 simply requires the disclosure of management personnel remuneration in total.

Entities

An entity is related to a reporting entity if the entity is controlled or jointly controlled by a person identified as a related party. Hence, the family trust is a related party of Bobarra. The family trust is controlled by related parties, the finance and sales directors, for the benefit of a close member of their family, i.e. their son. In the absence of evidence to the contrary, the third owner of the shares is not a related party. The person is a passive investor who does not appear to exert significant influence over Bobarra.

A related party relationship exists where the entity and the reporting entity are members of the same group, which means that each parent, subsidiary and fellow subsidiary is related to the others. However, FRS 102 states that disclosures need not be given of transactions entered into between two or more members of a group if any subsidiary which is a party to the transaction is wholly owned by such a member.

The transactions between Bobarra and Drumby would be disclosed as related party disclosures under both IAS 24 and FRS 102. Drumby is not wholly owned by any member of the group and hence the FRS 102 exemption does not apply. However, any transactions between Bobarra, Alucant and Cantor would be covered by the exemption from disclosure in FRS 102 even though the three entities are related parties.

Marking scheme		
		Marks
(a)	Companies Act – 1 mark per point	9
(b)	Related parties – 1 mark per point	7
Total		**16**

74 HARRIS

Key answer tips

One area where there are still large differences between International Financial Reporting Standards and UK GAAP is business combinations. Make sure that you memorise the examinable differences.

Deferred tax is a popular topic for UK specific questions because this section of FRS 102 is worded very differently from IAS 12.

(a) Goodwill

Consideration

IFRS 3 *Business Combinations* requires that contingent consideration is included in the calculation of goodwill at its fair value at the acquisition date. This fair value will incorporate the probability of payment. In contrast FRS 102 says that contingent consideration is only included in the calculation of goodwill if payment is probable.

IFRS 3 requires that any acquisition fees are expensed, whereas FRS 102 states that these should be included in the calculation of goodwill.

Non-controlling interest

Under IFRS 3, the non-controlling interest at the acquisition date can be measured at fair value or at its proportionate share of the fair value of the subsidiary's identifiable net assets. This decision is made on an acquisition by acquisition basis. FRS 102 only allows the proportionate method to be used.

Bargain purchase/negative goodwill

Under IFRS 3 *Business Combinations*, a gain on a bargain purchase is recognised immediately in the statement of profit or loss.

If a bargain purchase arises, FRS 102 requires the entity to:

- Reassess the identification and measurement of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination (this condition is the same as IFRS 3).
- Recognise and separately disclose the resulting excess on the face of the statement of financial position on the acquisition date (i.e. as a negative asset), immediately below goodwill, and followed by a subtotal of the net amount of goodwill and the excess.

- Recognise subsequently the excess up to the fair value of non-monetary assets acquired in profit or loss in the periods in which the non-monetary assets are recovered. Any excess exceeding the fair value of non-monetary assets acquired should be recognised in profit or loss in the periods expected to benefit.

(b) Deferred tax

Under IAS 12 *Income Taxes*, an entity recognises a deferred tax asset or liability for tax recoverable or payable in future periods as a result of past transactions or events. Such tax arises from the difference between the amounts recognised for the entity's assets and liabilities in the statement of financial position and the recognition of those assets and liabilities by the tax authorities plus the carry forward of currently unused tax losses and tax credits.

Under FRS 102, deferred tax is recognised in respect timing differences at the reporting date. Timing differences are differences between taxable profits and total comprehensive income as stated in the financial statements which arise from the inclusion of income and expenses in tax assessments in periods different from those in which they are recognised in financial statements. In addition, FRS 102 states that deferred tax should be recognised on the differences between the tax value and fair value of assets and liabilities acquired in a business combination, even though this impacts neither taxable profits nor total comprehensive income. As such, FRS 102 is said to adopt a 'timing difference plus' approach.

FRS 102 uses the term 'permanent difference', whereas IAS 12 does not use this term.

In practice it is unlikely that the differences between FRS 102 and IAS 12 will cause a significant difference in terms of the recognition and measurement of deferred tax assets and liabilities.

Marking scheme		
		Marks
(a)	Goodwill – 1 mark per point	9
(b)	Deferred tax – 1 mark per point	6
Total		**15**

75 ROWLING

Key answer tips

The UK specific syllabus content is very factual and needs to be learned by students sitting the UK exam. This question concerns the scope of the UK standards FRS 100, FRS 101, FRS 102 and FRS 105. This is core knowledge. If you struggled with this question, revisit the UK content in the Study Text.

The UK Standards

The Financial Reporting Council in the UK has published:

1 FRS 100 *Application of Financial Reporting Requirements*

2 FRS 101 *Reduced Disclosure Framework*

3 FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

4 FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime.*

FRS 100

FRS 100 sets out the overall financial reporting requirements, giving many entities a choice depending on factors such as size, and whether or not they are part of a listed group.

FRS 100 identifies whether entities need to produce their consolidated or individual financial statements in accordance with EU approved IFRS Standards or FRS 102.

FRS 101

FRS 101 provides companies with an opportunity to take advantage of reduced disclosures.

FRS 101 permits UK subsidiaries to adopt EU approved IFRS Standards for their individual financial statements but within the reduced disclosure framework. This option is also available for the parent company's individual financial statements.

FRS 102

FRS 102 adopts an IFRS Standard-based framework with proportionate disclosure requirements. It is based on the IFRS for SMEs Standard but with significant changes in order to address company law and to include extra accounting options.

FRS 105

Micro-entities can choose to prepare their financial statements in accordance with FRS 105.

FRS 105 is based on FRS 102 but with some amendments to satisfy legal requirements and to reflect the simpler nature of micro-entities.

For example, FRS 105:

- Prohibits accounting for deferred tax
- Prohibits accounting for equity-settled share-based payments before the issue of the shares
- Simplifies the rules around classifying a financial instrument as debt or equity
- Removes the distinction between functional and presentation currencies.

Intangible assets

Under UK GAAP, where certain criteria are met, an entity **may** capitalise development expenditure. Under IAS 38 *Intangible Assets*, an intangible asset arising from the development phase of an internal project **must** be capitalised if certain criteria are met.

If an intangible is acquired through a business combination and arises from legal or contractual rights then FRS 102 only permits its recognition if there is evidence of exchange transactions for similar assets. Under IFRS 3 *Business Combinations*, intangible assets acquired through a business combination are recognised if they are separable, or if they arise from legal or contractual rights.

Under FRS 102, goodwill is amortised over its useful economic life. If the useful economic life cannot be reliably determined then the estimate used should not exceed ten years. Under International Financial Reporting Standards, amortisation of goodwill is not permitted. Instead annual impairment testing is required.

Marking scheme	
	Marks
1 mark per valid point	15
Total	**15**

76 TOTO

Key answer tips

The recent issue of IFRS 16 *Leases* means that there are now significant differences between International Financial Reporting Standards and UK GAAP with regards to lessee accounting.

IFRS 16 *Leases*

With regards to lessee accounting, IFRS 16 *Leases* says that a lease liability and a right-of-use asset should be recognised at the inception of all leases (unless they are short-term or of low value). The lease liability will be measured at the present value of the lease payments yet to be made – the discount rate used should be the interest rate implicit in the lease. As there are no other costs or payments, the right-of-use asset will be measured at the same value.

Interest on the lease liability will be charged to profit or loss based on the rate implicit in the lease. The right-of-use asset will be depreciated over the three year lease term and this will be recorded in the statement of profit or loss.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

FRS 102 classifies leases as finance leases or operating leases. A finance lease is a lease where the risks and rewards of ownership transfer to the lessee. It would seem that the lease is an operating lease, because ownership of the asset does not transfer to Toto at the end of the lease term, and the lease term is much shorter than the asset's useful life.

As such, no asset or liability is would be recognised at the inception of the lease. Instead, lease rentals would be charged to profit or loss on a straight line basis.

Comparison of impact

Liabilities will be higher if the financial statements are prepared using IFRS Standards rather than FRS 102. This will make the entity look more highly geared and, potentially, riskier to investors. Under IFRS 16, some of the lease liability would be classified as current on the statement of financial position, having an adverse impact on the current ratio.

Non-current assets will be higher under IFRS Standards. This could be viewed positively because Toto will appear more asset rich. However, users may conclude that Toto is inefficient at generating returns from its assets, and so invest their money elsewhere.

The total lease expense over the three year period will be the same under both IFRS 16 and FRS 102. However, under IFRS 16, the lease expense is likely to be split between operating expenses (the depreciation on the right-of-use asset) and finance costs (the interest on the lease liability). Under FRS 102 it is likely that the full lease expense will be recorded against operating expenses. As such, IFRS 16 might result in Toto recording higher operating profits.

In the first year of the lease it is likely that IFRS 16 will result in lower profits than FRS 102. This is because IFRS 16 requires recognition of a lease liability and a larger interest expense will be recognised in the first year of the lease when the liability is highest. Lower profits will lead to lower earnings per share, which is a key ratio for assessing company performance and for deriving company valuations.

Marking scheme	
	Marks
1 mark per valid point	15
	—
Total	**15**
	—

77 HOWEY

Key answer tips

Remember you will score one mark per valid point that you make. This means that you would not be expected to reproduce the detail below. However, do try and memorise the key differences between International Financial Reporting Standards and UK GAAP. In particular, it is important to remember that there is no concept of 'held for sale' in FRS 102.

(a) Held for sale and discontinued operations

Held for sale

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* sets out requirements for the classification, measurement and presentation of non-current assets held for sale. Under IFRS 5, a non-current asset should be classified held for sale if its carrying amount will be recovered primarily through a sales transaction. At the date of meeting the criteria, such an asset will be measured at the lower of its carrying amount and fair value less costs to sell. Depreciation on the asset ceases.

FRS 102 does not refer to the concept of 'held for sale'. As such the asset will be depreciated or amortised until the disposal date. However, the decision to sell an asset does trigger an impairment review.

Discontinued operations

Under IFRS 5, an operation is classified as discontinued at the date the operation meets the criteria to be classified as held for sale or when the entity has disposed of the operation.

Because the concept of 'held for sale' is absent from FRS 102, an operation is classified as discontinued only if it has been disposed of.

With regards to discontinued operations, IFRS 5 requires a single number to be disclosed on the face of the statement of profit or loss, being the total of (i) the discontinued operations' post-tax profit/loss and (ii) the post-tax gain/loss recognised in the measurement of the fair value less costs to sell or on the disposal of the discontinued operations' assets. A breakdown of this number is required to be given either on the face of the statement of profit or loss or in the notes.

FRS 102 requires disclosure of the results of continuing operations and discontinued operations in separate columns on the face of the income statement.

Subsidiaries acquired exclusively for resale

Under IFRS 5, subsidiaries acquired exclusively with a view to resale that meet the conditions to be classified as held for sale are consolidated. However, their results are presented within the single line item for discontinued operations. In the statement of financial position they are presented as two separate items – assets, including goodwill, and liabilities.

Under FRS 102, subsidiaries acquired exclusively with a view to sell must be measured at either:

- Cost less impairment, or
- Fair value, with gains and losses recognised in profit or loss, or
- Fair value, with gains and losses recognised in other comprehensive income.

(b) Reasons for adopting FRS 102

There are various reasons why an entity might choose to prepare its financial statements in accordance with FRS 102 rather than IFRS Standards:

- FRS 102 is more accessibly worded than IFRS Standards.
- FRS 102 is a single accounting standard that is split into sections (such as 'revenue', 'leases' etc). This means that it is quicker and easier to navigate than IFRS Standards.
- Some accounting concepts are absent from FRS 102, such as 'assets held for sale'. Reducing the number of rules that entities must apply reduces the burden of financial reporting.
- FRS 102 permits some accounting policy choices that will help entities to simplify their financial reporting. For example, entities can choose to write off development expenditure and borrowing costs to profit or loss.
- Some FRS 102 rules are less time-consuming than their IFRS Standard equivalents. For instance, FRS 102 does not require the useful lives of property, plant and equipment to be reassessed annually.
- If other entities in the same sector also prepare financial statements in accordance with FRS 102 then it will make it easier to benchmark performance against them.
- There are far fewer disclosure requirements in FRS 102 than in full IFRS Standards.

Marking scheme		
		Marks
(a)	Held for sale and disc. operations – 1 mark per point	9
(b)	Reasons for adopting FRS 102 – 1 mark per point	6
Total		**15**

78 LOKI

Key answer tips

Although this question requires knowledge of the differences between IFRS Standards and UK GAAP, it also requires a thorough understanding of the impact of different ways of measuring the non-controlling interest. Students often struggle with this area. If you found this question difficult then revisit the chapter on 'basic groups' in the Study Text.

(a) International Financial Reporting Standards

IFRS 3 *Business Combinations* permits the NCI at acquisition to be measured at its fair value or at its proportionate share of the fair value of the subsidiary's identifiable net assets. This choice is made on an acquisition-by-acquisition basis.

Loki opts to measure the NCI at fair value so the calculation of goodwill arising at acquisition is as follows:

	$m
Fair value of consideration	300
Fair value of non-controlling interest	120
Fair value of identifiable net assets acquired	(280)
Goodwill at acquisition	140

Under IFRS Standards, goodwill is not amortised. Instead, IAS 36 *Impairment of Assets* stipulates that it is subject to annual impairment review. An asset, or cash generating unit, is impaired if its carrying amount exceeds its recoverable amount. The calculation of the impairment loss is as follows:

	$m
Goodwill	140
Net assets	260
Total	400
Recoverable amount	(350)
Impairment	50

IAS 36 requires that the impairment is firstly allocated against goodwill. The impairment will be charged to the statement of profit or loss:

Dr Profit or loss	\$50m
Cr Goodwill	\$50m

The carrying mount of goodwill will therefore be reduced to \$90 million (\$140m – \$50m). The expense will be allocated to the owners of the parent (\$35m) and the NCI (\$15m) in proportion to their shareholdings.

(b) FRS 102

FRS 102 does not permit the NCI at acquisition to be measured at fair value. As such, the proportionate method must be used. The calculation of goodwill would be as follows:

	\$m
Fair value of consideration	300
Non-controlling interest (30% × \$280m)	84
Fair value of identifiable net assets acquired	(280)
Goodwill at acquisition	104

In accordance with FRS 102, goodwill is amortised over its estimated useful economic life. By the year ended 31 December 20X2, the goodwill would have a carrying amount of \$83.2 million (\$104m × 8/10).

When performing an impairment review under FRS 102 (and under IAS 36 if the proportionate method for valuing the NCI has been used), goodwill will need to be notionally grossed up to include the NCI share.

The impairment will be calculated as follows:

	\$m	\$m
Goodwill	83.2	
Notional NCI (\$83.2m × 30/70)	35.7	
Total notional goodwill		118.9
Net assets at reporting date		260.0
Total carrying amount of assets		378.9
Recoverable amount		(350.0)
Impairment		28.9

The impairment is allocated to the total notional goodwill. However, only 70% of the total notional goodwill was recognised and so only 70% of the impairment should be recognised. Therefore, the charge in profit or loss will be \$20.2 million (\$28.9m × 70%) and goodwill will be reduced to \$63 million (\$83.2 – \$20.2m). All of the charge is attributable to the owners of the parent company.

Marking scheme		
		Marks
(a)	IFRS Standards and impairment – 1 mark per point	6
(b)	FRS 102 and impairment – 1 mark per point	9
Total		**15**

Section 3

SPECIMEN 1 EXAM QUESTIONS

1 KUTCHEN

Background and financial statements

The following group financial statements relate to the Kutchen Group which comprised Kutchen, House and Mach, all public limited companies.

Group statement of financial position as at 31 December 20X6

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

Acquisition of 70% of House

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

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

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

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

Initial acquisition of 80% of Mach

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

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

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