Acquisition and disposal of 80% of Niche

Kutchen purchased an 80% interest in Niche for $40 million on 1 January 20X6 when the fair value of the identifiable net assets was $44 million. The partial goodwill method had been used and an impairment of $2 million had arisen in the year ended 31 December 20X6. The holding in Niche was sold for $50 million on 31 December 20X6. The carrying amount of Niche's identifiable net assets other than goodwill was $60 million at the date of sale. Kutchen had carried the investment in Niche at cost in its separate financial statements. The finance director calculated that a gain arose of $2 million on the sale of Niche in the group financial statements being the sale proceeds of $50 million less $48 million being their share of the identifiable net assets at the date of sale (80% of $60 million). This was credited to retained earnings.

Business segment restructure

Kutchen has decided to restructure one of its business segments. The plan was agreed by the board of directors on 1 October 20X6 and affects employees in two locations. In the first location, half of the factory units have been closed by 31 December 20X6 and the affected employees' pension benefits have been frozen. Any new employees will not be eligible to join the defined benefit plan. After the restructuring, the present value of the defined benefit obligation in this location is $8 million. The following table relates to location 1.

	$m
Value before restructuring:	
Present value of defined benefit obligation	(10)
Fair value of plan assets	7
Net pension liability	(3)

In the second location, all activities have been discontinued. It has been agreed that employees will receive a payment of $4 million in exchange for the pension liability of $2.4 million in the unfunded pension scheme.

Kutchen estimates that the costs of the above restructuring excluding pension costs will be $6 million. Kutchen has not accounted for the effects of the restructuring in its financial statements because it is planning a rights issue and does not wish to depress the share price. Therefore there has been no formal announcement of the restructuring.

Subsequent acquisition of 20% of Mach

When Kutchen acquired the majority shareholding in Mach, there was an option on the remaining 20% non-controlling interest (NCI), which could be exercised at any time up to 31 March 20X7. On 31 January 20X7, Kutchen acquired the remaining NCI in Mach. The payment for the NCI was structured so that it contained a fixed initial payment and a series of contingent amounts payable over the following two years.

The contingent payments were to be based on the future profits of Mach up to a maximum amount. Kutchen felt that the fixed initial payment was an equity transaction. Additionally, Kutchen was unsure as to whether the contingent payments were equity, financial liabilities or contingent liabilities.

After a board discussion which contained disagreement as to the accounting treatment, Kutchen is preparing to disclose the contingent payments in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The disclosure will include the estimated timing of the payments and the directors' estimate of the amounts to be settled.

Required:

(a) (i) Explain to the directors of Kutchen, with suitable workings, how goodwill should have been calculated on the acquisition of House and Mach showing the adjustments which need to be made to the consolidated financial statements to correct any errors by the finance director. (10 marks)

(ii) Explain, with suitable calculations, how the gain or loss on the sale of Niche should have been recorded in the group financial statements. (5 marks)

(iii) Discuss, with suitable workings, how the pension scheme should be dealt with after the restructuring of the business segment and whether a provision for restructuring should have been made in the financial statements for the year ended 31 December 20X6. (7 marks)

Note: Marks will be allocated in (a) for a suitable discussion of the principles involved as well as the accounting treatment.

(b) Advise Kutchen on the difference between equity and liabilities, and on the proposed accounting treatment of the contingent payments on the subsequent acquisition of 20% of Mach. (8 marks)

(Total: 30 marks)

2 ABBY

Abby is a company which conducts business in several parts of the world.

Related party transactions

The accountant has discovered that the finance director of Abby has purchased goods from a company, Arwight, which the director jointly owns with his wife and the accountant believes that this purchase should be disclosed. However, the director refuses to disclose the transaction as in his opinion it is an 'arm's length' transaction. He feels that if the transaction is disclosed, it will be harmful to business and feels that the information asymmetry caused by such non-disclosure is irrelevant as most entities undertake related party transactions without disclosing them. Similarly, the director felt that competitive harm would occur if disclosure of operating segment profit or loss was made. As a result, the entity only disclosed a measure of total assets and total liabilities for each reportable segment.

When preparing the financial statements for the recent year end, the accountant noticed that Arwight has not paid an invoice for several million dollars and it is significantly overdue for payment. It appears that the entity has liquidity problems and it is unlikely that Arwight will pay. The accountant believes that a loss allowance for trade receivables is required. The finance director has refused to make such an allowance and has told the accountant that the issue must not be discussed with anyone within the trade because of possible repercussions for the credit worthiness of Arwight.

Subsidiary fair value adjustments

Additionally, when completing the consolidated financial statements, the director has suggested that there should be no positive fair value adjustments for a recently acquired subsidiary and has stated that the accountant's current position is dependent upon following these instructions. The fair value of the subsidiary is $50 million above the carrying amount in the financial records. The reason given for not fair valuing the subsidiary's net assets is that goodwill is an arbitrary calculation which is meaningless in the context of the performance evaluation of an entity.

Goodwill impairment calculation

Finally, when preparing the annual impairment tests of goodwill arising on other subsidiaries, the director has suggested that the accountant is flexible in the assumptions used in calculating future expected cash flows, so that no impairment of goodwill arises and that the accountant should use a discount rate which reflects risks for which future cash flows have been adjusted. He has indicated that he will support a salary increase for the accountant if she follows his suggestions.

Required:

Discuss the ethical and accounting implications of the above situations from the perspective of the reporting accountant. (18 marks)

Professional marks will be awarded in question 2 for the application of ethical principles. (2 marks)

(Total: 20 marks)

3 AFRICANT

(a) Africant owns several farms and also owns a division which sells agricultural vehicles. It is considering selling this agricultural retail division and wishes to measure the fair value of the inventory of vehicles for the purpose of the sale. Three markets currently exist for the vehicles. Africant has transacted regularly in all three markets.

At 31 December 20X5, Africant wishes to find the fair value of 150 new vehicles, which are identical. The current volume and prices in the three markets are as follows:

Market	**Sales price per vehicle** $	**Historical volume – vehicles sold by Africant**	**Total volume of vehicles sold in the market**	**Transaction costs per vehicle** $	**Transport cost to market per vehicle** $
Europe	40,000	6,000	150,000	500	400
Asia	38,000	2,500	750,000	400	700
Africa	34,000	1,500	100,000	300	600

Africant wishes to value the vehicles at $39,100 per vehicle as these are the highest net proceeds per vehicle, and Europe is the largest market for Africant's product.

(i) Africant wishes to understand the principles behind the valuation of the new vehicles and also whether their valuation would be acceptable under IFRS 13 *Fair Value Measurement*. **(8 marks)**

(ii) Africant uses the revaluation model for its non-current assets. Africant has several plots of farmland which are unproductive. The company feels that the land would have more value if it were used for residential purposes. There are several potential purchasers for the land but planning permission has not yet been granted for use of the land for residential purposes. However, preliminary enquiries with the regulatory authorities seem to indicate that planning permission may be granted. Additionally, the government has recently indicated that more agricultural land should be used for residential purposes.

Africant has also been approached to sell the land for commercial development at a higher price than that for residential purposes and understands that fair value measurement of a non-financial asset takes into account a market perspective.

Africant would like an explanation of what is meant by a 'market perspective' and advice on how to measure the fair value of the land in its financial statements. **(7 marks)**

Required:

Advise Africant on the matters set out above (in (i) and (ii)) with reference to relevant IFRS Standards.

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

(b) Africant is about to hold its annual general meeting with shareholders and the directors wish to prepare for any potential questions which may be raised at the meeting. There have been discussions in the media over the fact that the most relevant measurement method should be selected for each category of assets and liabilities. This 'mixed measurement approach' is used by many entities when preparing financial statements. There have also been comments in the media about the impact that measurement uncertainty and price volatility can have on the quality of financial information.

Required:

Discuss the impact which the above matters may have on the analysis of financial statements by investors in Africant. **(8 marks)**

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

(Total: 25 marks)

4 RATIONALE

The directors of Rationale are reviewing the published financial statements of the group. The following is an extract of information to be found in the financial statements.

Year ended		**31 December 20X6**	**31 December 20X5**
		$m	$m
Net profit/(loss) before taxation and after the items set out below		(5)	38
Net interest expense		10	4
Depreciation		9	8
Amortisation of intangible assets		3	2
Impairment of property	10		
Insurance proceeds	(7)	3	
Debt issue costs		2	
Share-based payment		3	1
Restructuring charges		4	
Impairment of acquired intangible assets		6	8

The directors use 'underlying profit' to comment on its financial performance. Underlying profit is a measure normally based on earnings before interest, tax, depreciation and amortisation (EBITDA). However, the effects of events which are not part of the usual business activity are also excluded when evaluating performance.

The following items were excluded from net profit to arrive at 'underlying profit'. In 20X6, the entity had to write off a property due to subsidence and the insurance proceeds recovered for this property was recorded but not approved until 20X7, when the company's insurer concluded that the claim was valid. In 20X6, the entity considered issuing loan notes to finance an asset purchase, however, the purchase did not go ahead. The entity incurred costs associated with the potential issue and so these costs were expensed as part of net profit before taxation. The entity felt that the share-based payment was not a cash expense and that the value of the options was subjective. Therefore, the directors wished to exclude the item from 'underlying profit'. Similarly, the directors wish to exclude restructuring charges incurred in the year, and impairments of acquired intangible assets.

Required:

(a) (i) Discuss the reasons why an entity may wish to disclose additional performance information in its financial statements and the concerns this may raise.

(5 marks)

(ii) Discuss the use and the limitations of the proposed calculation of 'underlying profit' by Rationale. Your answer should include a comparative calculation of underlying profit for the years ended 31 December 20X5 and 20X6.

(12 marks)

(b) The directors of Rationale are confused over the nature of a reclassification adjustment and understand that the Board has recently revised the *Conceptual Framework* to cover this issue.

Required:

(i) Discuss, with examples and reference to the *Conceptual Framework*, the nature of a reclassification adjustment (5 marks)

(ii) Discuss arguments against allowing reclassification of items from other comprehensive income to profit or loss. (3 marks)

(Total: 25 marks)

Section 4

SPECIMEN 1 EXAM ANSWERS

1 KUTCHEN

(a) (i) Goodwill

Goodwill on the acquisition of House and Mach should have been calculated as follows:

House

	$m
Fair value of consideration for 70% interest	42.00
Fair value of non-controlling interest (see below)	16.38
Fair value of identifiable net assets acquired	(48.00)
Goodwill	10.38

Contingent consideration should be valued at fair value and will have to take into account the various milestones set under the agreement. The expected value is (20% × 5 million shares) 1 million shares × $2, i.e. $2 million. This is equity so there will be no remeasurement of the fair value in subsequent periods. The contingent consideration will be recorded in other components of equity. The fair value of the consideration is therefore 20 million shares at $2 plus $2 million (above), i.e. $42 million.

The fair value of the NCI is 30% × 13 million × $4.20 = $16.38 million.

The finance director has not taken into account the fair value of the NCI in the valuation of goodwill or the contingent consideration. If the difference between the fair value of the consideration, NCI and the identifiable net assets is negative, the resulting gain is a bargain purchase in profit or loss, which may arise in circumstances such as a forced seller acting under compulsion. However, before any bargain purchase gain is recognised in profit or loss, and hence in retained earnings in the group statement of financial position, the finance director should have undertaken a review to ensure the identification of assets and liabilities is complete, and that measurements appropriately reflect consideration of all available information.

The adjustment to the group financial statements would be as follows:

Dr Goodwill	$10.38 million
Dr Profit or loss	$8 million
Cr NCI	$16.38 million
Cr OCE	$2 million

Mach

Net profit of Mach for the year to 31 December 20X5 is $3.6 million. The P/E ratio (adjusted) is 19. Therefore the fair value of Mach is 19 × $3.6 million, i.e. $68.4 million. The NCI has a 20% holding, so the fair value of the NCI is $13.68 million.

	$m
Fair value of consideration for 80% interest ($52m + $5m)	57
Fair value of non-controlling interest	13.68
Fair value of identifiable net assets acquired	(55)
Goodwill	15.68

The land transferred as part of the purchase consideration should be valued at its acquisition date fair value of $5 million and included in the goodwill calculation. Therefore the increase of $2 million over the carrying amount should be shown in retained earnings.

Dr PPE	$2 million
Cr Retained earnings	$2 million

The adjustment to the group financial statements would be as follows:

Dr Goodwill	$15.68 million
Dr Retained earnings	$3 million
Cr NCI	$13.68 million
Cr PPE	$5 million

Total goodwill is therefore $26.06 million ($15.68m + $10.38m).

(ii) Niche

The gain or loss on sale should have been calculated as the difference between the proceeds received of $50 million and the carrying amount of the subsidiary in the consolidated financial statements at the date of disposal.

The correct calculation is as follows:

	$m
Sale proceeds	50.0
Goodwill at disposal (W1)	(2.8)
Net assets at disposal	(60.0)
NCI at disposal (W2)	12.0
Loss on sale of Niche in group profit or loss	(0.8)

(W1) Goodwill

	$m
Fair value of consideration for 70% interest	40.0
Non-controlling interest ($44m × 20%)	8.8
Fair value of identifiable net assets acquired	(44.0)
Goodwill at acquisition	4.8
Impairment	(2.0)
Goodwill at disposal	2.8

(W2) NCI at disposal

	$m
NCI at acquisition	8.8
NCI share of post-acquisition net assets 20% × ($60m – $44m)	3.2
NCI at disposal	12.0

(iii) After restructuring, the present value of the pension liability in location 1 is reduced to $8 million. Thus there will be a negative past service cost in this location of $2 million ($10m – $8m). As regards location 2, there is a settlement and a curtailment as all liability will be extinguished by the payment of $4 million. Therefore there is a loss of $1.6 million ($2.4m – $4m). The changes to the pension scheme in locations 1 and 2 will both affect profit or loss as follows:

Location 1

Dr Pension obligation	$2m
Cr Retained earnings	$2m

Location 2

Dr Pension obligation	$2.4m
Dr Retained earnings	$1.6m
Cr Current liabilities	$4m

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that a provision for restructuring should be made only when a detailed formal plan is in place and the entity has started to implement the plan, or announced its main features to those affected. A board decision is insufficient. Even though there has been no formal announcement of the restructuring, Kutchen has started implementing it and therefore it must be accounted for under IAS 37.

A provision of $6 million should also be made at the year end.

(b) The *Conceptual Framework* defines a liability as a present obligation, arising from past events, to transfer an economic resource. IAS 32 *Financial Instruments: Presentation* establishes principles for presenting financial instruments as liabilities or equity. The key feature of a financial liability is that the issuer has a contractual obligation to deliver either cash or another financial asset to the holder. An obligation may arise from a requirement to repay principal or interest or dividends.

In contrast, equity has a residual interest in the entity's assets after deducting all of its liabilities. An equity instrument includes no obligation to deliver cash or another financial asset to another entity. A contract which will be settled by the entity delivering a fixed number of its own equity instruments in exchange for cash or another financial asset is an equity instrument. However, if there is any variability in the amount of equity instruments which will be delivered then such a contract is a financial liability.

Contingent consideration for a business must be recognised at the time of acquisition, in accordance with IFRS 3 *Business Combinations*. IFRS Standards do not contain any guidance when accounting for contingent consideration for the acquisition of a NCI in a subsidiary but the contract for contingent payments does meet the definition of a financial liability under IAS 32. Kutchen has an obligation to pay cash to the vendor of the NCI under the terms of a contract. It is not within Kutchen's control to be able to avoid that obligation. The amount of the contingent payments depends on the profitability of Mach, which itself depends on a number of factors which are uncontrollable. IAS 32 states that a contingent obligation to pay cash which is outside the control of both parties to a contract meets the definition of a financial liability which shall be initially measured at fair value. Since the contingent payments relate to the acquisition of the NCI, the offsetting entry would be recognised directly in equity.

Marking scheme

			Marks
(a)	(i)	– application of the following discussion to the scenario:	
		contingent consideration	2
		NCI	2
		fair value of assets acquired	2
		– goodwill calculations and corrections required	4
	(ii)	– application of the following discussion to the scenario:	
		proceeds	1
		carrying amount of the assets disposed of	1
		– calculation of the gain/loss on disposal of Niche	3
	(iii)	– application of the following discussion to the scenario:	
		present value and past service cost	2
		– calculation of SOPL effect	3
		– consideration of a restructuring provision	2
(b)	– application of the following discussion to the scenario:		
		definition of a liability and IAS 32 (liability v equity)	2
		definition of equity	2
		consideration of contingent payments of Mach	4
Total			**30**

2 ABBY

Related party transaction

The objective of IAS 24 *Related Party Disclosures* is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties. If there have been transactions between related parties, there should be disclosure of the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. The director is a member of the key management personnel of the reporting entity and the entity from whom the goods were purchased is jointly controlled by that director. Therefore a related party relationship exists and should be disclosed.

IFRS 8 *Operating Segments* requires an entity to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments which meet specified criteria. IFRS 8 does not contain a 'competitive harm' exemption and requires entities to disclose the financial information which is provided by the chief operating decision maker (CODM). The management accounts reviewed by the CODM may contain commercially sensitive information, and IFRS 8 might require that information to be disclosed externally. Under IFRS 8, firms should provide financial segment disclosures which enable investors to assess the different sources of risk and income as management does. This sensitive information would also be available for competitors. The potential competitive harm may encourage firms to withhold segment information. However, this is contrary to IFRS 8 which requires information about the profit or loss for each reportable segment, including certain specified revenues and expenses such as revenue from external customers and from transactions with other segments, interest revenue and expense, depreciation and amortisation, income tax expense or income and material non-cash items.

Areas such as impairments of financial assets often involve the application of professional judgement. The director may have received additional information, which has allowed him to form a different opinion to that of the accountant. The matter should be discussed with the director to ascertain why no allowance is required and to ask whether there is additional information available. However, suspicion is raised by the fact that the accountant has been told not to discuss the matter. Whilst there may be valid reasons for this, it appears again that the related party relationship is affecting the judgement of the director.

Subsidiary fair value adjustments

Positive fair value adjustments increase the assets of the acquired company and as such reduce the goodwill recognised on consolidation. However, the majority of positive fair value adjustments usually relate to items of property, plant and equipment. As a result, extra depreciation based on the net fair value adjustment reduces the post-acquisition profits of the subsidiary. This has a negative impact on important financial performance measures such as EPS. Therefore, by reducing fair value adjustments it will improve the apparent performance of new acquisitions and the consolidated financial statements. Accountants should act ethically and ignore undue pressure to undertake creative accounting in preparing such adjustments. Guidance such as IFRS 3 *Business Combinations* and IFRS 13 *Fair Value Measurement* should be used in preparing adjustments and professional valuers should be engaged where necessary.

Goodwill impairment calculation

In measuring value in use, the discount rate used should be the pre-tax rate which reflects current market assessments of the time value of money and the risks specific to the asset. The discount rate should not reflect risks for which future cash flows have been adjusted and should equal the rate of return which investors would require if they were to choose an investment which would generate cash flows equivalent to those expected from the asset. By reducing the impairment, it would have a positive impact on the financial statements. The offer of a salary increase is inappropriate and no action should be taken until the situation is clarified. Inappropriate financial reporting raises issues and risks for those involved and others associated with the company. Whilst financial reporting involves judgement, it would appear that this situation is related to judgement.

Ethics

There are several potential breaches of accounting standards and unethical practices being used by the director. The director is trying to coerce the accountant into acting unethically. IAS 1 *Presentation of Financial Statements* requires all standards to be applied if fair presentation is to be obtained. Directors cannot choose which standards they do or do not apply. It is important that accountants identify issues of unethical practice and act appropriately in accordance with ACCA's *Codes of Ethics*. The accountant should discuss the matters with the director. The technical issues should be explained and the risks of non-compliance explained to the director. If the director refuses to comply with accounting standards, then it would be appropriate to discuss the matter with others affected such as other directors and seek professional advice from ACCA. Legal advice should be considered if necessary.

An accountant who comes under pressure from senior colleagues to make inappropriate valuations and disclosures should discuss the matter with the person suggesting this. The discussion should try to confirm the facts and the reporting guidance which needs to be followed. Financial reporting does involve judgement but the cases above seem to be more than just differences in opinion. The accountant should keep a record of conversations and actions and discuss the matters with others affected by the decision, such as directors. Additionally, resignation should be considered if the matters cannot be satisfactorily resolved.

Marking scheme

	Marks
– application of the following discussion of accounting issues to the scenario:	
related party transactions	2
competitive harm exemptions	2
impairment of financial assets	2
fair value adjustments	2
goodwill impairment review	2
– application of the following discussion of ethical issues to the scenario:	
potential breaches	4
advice to accountant	4
Professional	2
Total	**20**

3 AFRICANT

(a) (i) Vehicle valuation

IFRS 13 *Fair Value Measurement* says that fair value is an exit price in the principal market, which is the market with the highest volume and level of activity. It is not determined based on the volume or level of activity of the reporting entity's transactions in a particular market. Once the accessible markets are identified, market-based volume and activity determines the principal market. There is a presumption that the principal market is the one in which the entity would normally enter into a transaction to sell the asset or transfer the liability, unless there is evidence to the contrary. In practice, an entity would first consider the markets it can access. In the absence of a principal market, it is assumed that the transaction would occur in the most advantageous market. This is the market which would maximise the amount which would be received to sell an asset or minimise the amount which would be paid to transfer a liability, taking into consideration transport and transaction costs. In either case, the entity must have access to the market on the measurement date. Although an entity must be able to access the market at the measurement date, IFRS 13 does not require an entity to be able to sell the particular asset or transfer the particular liability on that date. If there is a principal market for the asset or liability, the fair value measurement represents the price in that market at the measurement date regardless of whether that price is directly observable or estimated using another valuation technique and even if the price in a different market is potentially more advantageous.

In Africant's case, Asia is the principal market as this is the market in which the majority of transactions for the vehicles occur. The most advantageous market would be Europe where a net price of $39,100 (after all costs) would be gained by selling there and the number of vehicles sold in this market is at its highest. Africant would therefore utilise the fair value calculated by reference to the Asian market as this is the principal market.

IFRS 13 makes it clear that the price used to measure fair value must not be adjusted for transaction costs, but should consider transportation costs. Transaction costs are not deemed to be a characteristic of an asset or a liability but they are specific to a transaction and will differ depending on how an entity enters into a transaction.

As such, the fair value of the 150 vehicles would be $5,595,000 ($38,000 – $700 = $37,300 × 150).

(ii) Fair value of land

A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant who would use the asset in its highest and best use. The maximum value of a non-financial asset may arise from its use in combination with other assets or by itself. IFRS 13 requires the entity to consider uses which are physically possible, legally permissible and financially feasible. The use must not be legally prohibited. For example, if the land is protected in some way by law and a change of law is required, then it cannot be the highest and best use of the land.

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

Africant would need to have sufficient evidence to support its assumption about the potential for an alternative use, particularly in light of IFRS 13's presumption that the highest and best use is an asset's current use. Africant's belief that planning permission was possible is unlikely to be sufficient evidence that the change of use is legally permissible. However, the fact the government has indicated that more agricultural land should be released for residential purposes may provide additional evidence as to the likelihood that the land being measured should be based upon residential value. Africant would need to prove that market participants would consider residential use of the land to be legally permissible. Provided there is sufficient evidence to support these assertions, alternative uses, for example, commercial development which would enable market participants to maximise value, should be considered, but a search for potential alternative uses need not be exhaustive. In addition, any costs to transform the land, for example, obtaining planning permission or converting the land to its alternative use, and profit expectations from a market participant's perspective should also be considered in the fair value measurement.

If there are multiple types of market participants who would use the asset differently, these alternative scenarios must be considered before concluding on the asset's highest and best use. It appears that Africant is not certain about what constitutes the highest and best use and therefore IFRS 13's presumption that the highest and best use is an asset's current use appears to be valid at this stage.

(b) Mixed measurement

Some investors might argue in favour of a single measurement basis for all recognised assets and liabilities as the resulting totals and subtotals can have little meaning if different measurement methods are used. Similarly, profit or loss may lack relevance if it reflects a combination of flows based on historical cost and of value changes for items measured on a current value basis.

However, the majority of investors would tend to favour a mixed measurement approach, whereby the most relevant measurement method is selected for each category of assets and liabilities. This approach is consistent with how investors analyse financial statements. The problems of mixed measurement are outweighed by the greater relevance achieved if the most relevant measurement basis is used for each class of assets and liabilities. The mixed measurement approach is reflected in recent standards; for example, IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts* with Customers. Historical cost would not have been relevant for all financial assets and has severe limitations for many liabilities; hence, the only viable single measurement method would have been fair value. The *Conceptual Framework* does not propose a single measurement method for assets and liabilities, and instead supports the continued use of a mixed measurement approach.

Most accounting measures of assets and liabilities are uncertain and require estimation. While some measures of historical cost are straightforward as it is the amount paid or received, there are many occasions when the measurement of cost can be uncertain – particularly recoverable cost, for which impairment and depreciation estimates are required. In a similar vein, while some measures of fair value can be easily observed because of the availability of prices in an actively traded market (a so-called 'Level 1' fair value), others inevitably rely on management estimates and judgements ('Level 2' and 'Level 3').

High measurement uncertainty might reduce the quality of information available to investors. High price volatility may make analysing an investment in that entity more challenging. If a relevant measure of an asset or liability value is volatile, this should not be hidden from investors. To conceal its volatility would decrease the usefulness of the financial statements. Of course, such volatile gains and losses do need to be clearly presented and disclosed, because their predictive value may differ from that provided by other components of performance.

Marking scheme			
			Marks
(a)	(i)	– discussion of the principles of IFRS 13	4
		– application of the IFRS 13 principles to Africant	4
	(ii)	– market perspective and highest and best use	4
		– application of highest and best use to Africant	3
(b)	– single v mixed measurement and investor issues		2
	– examples		2
	– investor issues re uncertainty		2
	– investor issues re price volatility		2
	Professional		2
Total			**25**

4 RATIONALE

(a) (i) Reasons for disclosure of additional performance information

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

Problems caused by disclosure of additional performance information

There are concerns relating to the disclosure of additional information. There is no specific guidance on information which is not required by an IFRS being disclosed in financial statements. Such information may not readily be derived or reconciled back to financial statements. There is also difficulty comparing information across periods and between entities because of the lack of standardised approaches. Also the presentation of additional information may be inconsistent with that defined or specified in IFRS and the entity may present an excessively optimistic picture of an entity's financial performance. Non-IFRS information may make it difficult to identify the complete set of financial statements, including whether the information is audited or not. Additionally, the information may be given undue prominence or credibility merely because of its location within the financial statements. Non-IFRS financial information should be clearly labelled in a way that distinguishes it from the corresponding IFRS financial information. Any term used to describe the information should be appropriate having regard to the nature of the information. The term or label should not cause confusion with IFRS information and should accurately describe the measure.

(ii) Management performance measure

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

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

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

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

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

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

Year ended	**31 December 20X6**	**31 December 20X5**
	$m	$m
Net profit/(loss) before taxation and after the items set out below	(5)	38
Net interest expense	10	4
Depreciation	9	8
Amortisation of intangible assets	3	2
	–––	–––
EBITDA	17	52
Impairment of property	10	
Insurance recovery	(7)	–
Debt issue costs	2	
	–––	–––
EBITDA after non-recurring items	22	52
Share-based payment	3	1
Restructuring charges	4	
Impairment of acquired intangible assets	6	8
	–––	–––
Underlying profit	35	61
	–––	–––

(b) (i) The nature of reclassification adjustments

Reclassification adjustments are amounts recorded in profit or loss in the current period which were recognised in OCI in the current or previous periods.

According to the *Conceptual Framework*, 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. However, when developing or revising an IFRS Standard, the Board may decide that reclassification is not appropriate if there is no clear basis for identifying the amount or timing of the reclassification.

Examples of items recognised in OCI which may be reclassified to profit or loss are foreign currency gains on the disposal of a foreign operation and realised gains or losses on cash flow hedges.

Items which are not reclassified include changes in a revaluation surplus under IAS 16 *Property, Plant and Equipment*, and remeasurement gains and losses on a defined benefit plan under IAS 19 *Employee Benefits*.

(ii) Arguments against reclassification

Those against reclassification believe that it adds complexity to financial reporting because it is not fully understood by user groups. It is also argued that reclassification adjustments do not meet the definitions of income or expense in the *Conceptual Framework* because the change in the asset or liability may have occurred in a previous period.

The lack of a consistent basis in the 2010 *Conceptual Framework* for determining how items should be presented has led to an inconsistent use of OCI across IFRS Standards. Opinions vary but there is a feeling that OCI has become a place where the Board decide to put controversial gains or losses. Many users are thought to ignore OCI, as the changes reported are not caused by recurring trade activities and are therefore irrelevant to predicting future performance.

Marking scheme

			Marks
(a)	(i)	– reasons for disclosures	1
		– problems caused by disclosures	4
	(ii)	– the potential use, misuse and manipulation of EBITDA	5
(b)		– application of use/misuse of EBITDA by Rationale	4
		– calculation of underlying profit of Rationale	3
	(i)	– nature of reclassification adjustment	5
Total	(ii)	– arguments against reclassification	3
			25

Section 5

SPECIMEN 2 EXAM QUESTIONS

1 HILL

Background

Hill is a public limited company which has investments in a number of other entities. All of these entities prepare their financial statements in accordance with International Financial Reporting Standards. Extracts from the draft individual statements of profit or loss for Hill, Chandler and Doyle for the year ended 30 September 20X6 are presented below.

	Hill	**Chandler**	**Doyle**
	\$m	\$m	\$m
Profit/(loss) before taxation	(45)	67	154
Taxation	9	(15)	(31)
Profit/(loss) for the period	(36)	52	123

Acquisition of 80% of Chandler

Hill purchased 80% of the ordinary shares of Chandler on 1 October 20X5. Cash consideration of \$150 million has been included when calculating goodwill in the consolidated financial statements. The purchase agreement specified that a further cash payment of \$32 million becomes payable on 1 October 20X7 but no entries have been posted in the consolidated financial statements in respect of this. A discount rate of 5% should be used.

In the goodwill calculation, the fair value of Chandler's identifiable net assets was assessed as \$170 million. Of this, \$30 million related to Chandler's non-depreciable land. However, on 31 December 20X5, a survey was received which revealed that the fair value of this land was actually only \$20 million as at the acquisition date. No adjustments have been made to the goodwill calculation in respect of the results of the survey. The non-controlling interest at acquisition was measured using the proportionate method as \$34 million (\$170m × 20%).

As at 30 September 20X6, the recoverable amount of Chandler was calculated as \$250 million. No impairment has been calculated or accounted for in the consolidated financial statements.

Disposal of 20% holding in Doyle

On 1 October 20X4, Hill purchased 60% of the ordinary shares of Doyle. At this date, the fair value of Doyle's identifiable net assets was \$510 million. The non-controlling interest at acquisition was measured at its fair value of \$215 million. Goodwill arising on the acquisition of Doyle was \$50 million and had not been impaired prior to the disposal date. On 1 April 20X6, Hill disposed of a 20% holding in the shares of Doyle for cash consideration of \$140 million. At this date, the net assets of Doyle, excluding goodwill, were carried in the consolidated financial statements at \$590 million.

From 1 April 20X6, Hill has the ability to appoint two of the six members of Doyle's board of directors. The fair value of Hill's 40% shareholding was $300 million at that date.

Issue of convertible bond

On 1 October 20X5, Hill issued a convertible bond at par value of $20 million and has recorded it as a non-current liability. The bond is redeemable for cash on 30 September 20X7 at par. Bondholders can instead opt for conversion in the form of a fixed number of shares. Interest on the bond is payable at a rate of 4% a year in arrears. The interest paid in the year has been presented in finance costs. The interest rate on similar debt without a conversion option is 10%.

Discount factors

Year	**Discount rate 5%**	**Discount rate 10%**
1	0.952	0.909
2	0.907	0.826

Required

(a) (i) In respect of the investment in Chandler, explain, with suitable calculations, how goodwill should have been calculated, and show the adjustments which need to be made to the consolidated financial statements for this as well as any implications of the recoverable amount calculated at 30 September 20X6. (13 marks)

(ii) Discuss, with suitable calculations, how the investment in Doyle should be dealt with in the consolidated financial statements for the year ended 30 September 20X6. (7 marks)

(iii) Discuss, with suitable calculations, how the convertible bond should be dealt with in the consolidated financial statements for the year ended 30 September 20X6, showing any adjustments required. (6 marks)

(b) Hill has made a loss in the year ended 30 September 20X6, as well as in the previous two financial years. In the consolidated statement of financial position it has recognised a material deferred tax asset in respect of the carry-forward of unused tax losses. These losses cannot be surrendered to other group companies. On 30 September 20X6, Hill breached a covenant attached to a bank loan which is due for repayment in 20X9. The loan is presented in non-current liabilities on the statement of financial position. The loan agreement terms state that a breach in loan covenants entitles the bank to demand immediate repayment of the loan. Hill and its subsidiaries do not have sufficient liquid assets to repay the loan in full. However, on 1 November 20X6 the bank confirmed that repayment of the loan would not be required until the original due date.

Hill has produced a business plan which forecasts significant improvement in its financial situation over the next three years as a result of the launch of new products which are currently being developed.

Required:

Discuss the proposed treatment of Hill's deferred tax asset and the financial reporting issues raised by its loan covenant breach. (9 marks)

(Total: 35 marks)

2 GUSTOSO

Gustoso is a public limited company which produces a range of luxury Italian food products which are sold to restaurants, shops and supermarkets. It prepares its financial statements in accordance with International Financial Reporting Standards. The directors of Gustoso receive a cash bonus each year if reported profits for the period exceed a pre-determined target. Gustoso has performed in excess of targets in the year ended 31 December 20X7. Forecasts for 20X8 are, however, pessimistic due to economic uncertainty and stagnant nationwide wage growth.

Provisions

A new accountant has recently started work at Gustoso. She noticed that the provisions balance as at 31 December 20X7 is significantly higher than in the prior year. She made enquiries of the finance director, who explained that the increase was due to substantial changes in food safety and hygiene laws which become effective during 20X8. As a result, Gustoso must retrain a large proportion of its workforce. This retraining has yet to occur, so a provision has been recognised for the estimated cost of $2 million. The finance director then told the accountant that such enquiries were a waste of time and would not be looked at favourably when deciding on her future pay rise and bonuses.

Wheat contract

Gustoso purchases significant quantities of wheat for use in its bread and pasta products. These are high-value products on which Gustoso records significant profit margins. Nonetheless, the price of wheat is volatile and so, on 1 November 20X7, Gustoso entered into a contract with a supplier to purchase 500,000 bushels of wheat in June 20X8 for $5 a bushel. The contract can be settled net in cash. Gustoso has entered into similar contracts in the past and has always taken delivery of the wheat. By 31 December 20X7 the price of wheat had fallen. The finance director recorded a derivative liability of $0.5 million on the statement of financial position and a loss of $0.5 million in the statement of profit or loss. Wheat prices may rise again before June 20X8. The accountant is unsure if the current accounting treatment is correct but feels uncomfortable approaching the finance director again.

Required:

Discuss the ethical and accounting implications of the above situations from the perspective of the accountant. (13 marks)

Professional marks will be awarded in question 2 for the application of ethical principles. (2 marks)

(Total: 15 marks)

3 CALENDAR

Calendar has a reporting date of 31 December 20X7. It prepares its financial statements in accordance with International Financial Reporting Standards. Calendar develops biotech products for pharmaceutical companies. These pharmaceutical companies then manufacture and sell the products. Calendar receives stage payments during product development and a share of royalties when the final product is sold to consumers. A new accountant has recently joined Calendar's finance department and has raised a number of queries.

(a) **(i)** During 20X6 Calendar acquired a development project through a business combination and recognised it as an intangible asset. The commercial director decided that the return made from the completion of this specific development project would be sub-optimal. As such, in October 20X7, the project was sold to a competitor. The gain arising on derecognition of the intangible asset was presented as revenue in the financial statements for the year ended 31 December 20X7 on the grounds that development of new products is one of Calendar's ordinary activities. Calendar has made two similar sales of development projects in the past, but none since 20X0.

The accountant requires advice about whether the accounting treatment of this sale is correct. **(6 marks)**

(ii) While searching for some invoices, the accountant found a contract which Calendar had entered into on 1 January 20X7 with Diary, another entity. The contract allows Calendar to use a specific aircraft owned by Diary for a period of three years. Calendar is required to make annual payments.

On 1 January 20X7, costs were incurred negotiating the contract. The first annual payment was made on 31 December 20X7. Both of these amounts have been expensed to the statement of profit or loss.

There are contractual restrictions concerning where the aircraft can fly. Subject to those restrictions, Calendar determines where and when the aircraft will fly, and the cargo and passengers which will be transported.

Diary is permitted to substitute the aircraft at any time during the three-year period for an alternative model and must replace the aircraft if it is not working. Any substitute aircraft must meet strict interior and exterior specifications outlined in the contract. There are significant costs involved in outfitting an aircraft to meet Calendar's specifications.

The accountant requires advice as to the correct accounting treatment of this contract. **(9 marks)**

Required:

Advise the accountant on the matters set out above with reference to International Financial Reporting Standards.

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

(b) The new accountant has been reviewing Calendar's financial reporting processes. She has recommended the following:

– All purchases of property, plant and equipment below $500 should be written off to profit or loss. The accountant believes that this will significantly reduce the time and cost involved in maintaining detailed financial records and producing the annual financial statements.

– A checklist should be used when finalising the annual financial statements to ensure that all disclosure notes required by specific IFRS and IAS Standards are included.

Required:

With reference to the concept of materiality, discuss the acceptability of the above two proposals.

Note: Your answer should refer to IFRS Practice Statement: *Making Materiality Judgements*. **(10 marks)**

(Total: 25 marks)

4 KIKI

(a) Kiki is a public limited entity. It designs and manufactures children's toys. It has a reporting date of 31 December 20X7 and prepares its financial statements in accordance with International Financial Reporting Standards. The directors require advice about the following situations.

(i) Kiki sells $50 gift cards. These can be used when purchasing any of Kiki's products through its website. The gift cards expire after 12 months. Based on significant past experience, Kiki estimates that its customers will redeem 70% of the value of the gift card and that 30% of the value will expire unused. Kiki has no requirement to remit any unused funds to the customer when the gift card expires unused.

The directors are unsure about how the gift cards should be accounted for. **(6 marks)**

(ii) Kiki's best-selling range of toys is called Scarimon. In 20X6 Colour, another listed company, entered into a contract with Kiki for the rights to use Scarimon characters and imagery in a monthly comic book. The contract terms state that Colour must pay Kiki a royalty fee for every issue of the comic book which is sold. Before signing the contract, Kiki determined that Colour had a strong credit rating. Throughout 20X6, Colour provided Kiki with monthly sales figures and paid all amounts due in the agreed-upon period. At the beginning of 20X7, Colour experienced cash flow problems. These were expected to be short term. Colour made nominal payments to Kiki in relation to comic sales for the first half of the year. At the beginning of July 20X7, Colour lost access to credit facilities and several major customers. Colour continued to sell Scarimon comics online and through specialist retailers but made no further payments to Kiki.

The directors are unsure how to deal with the above issues in the financial statements for the year ended 31 December 20X7. **(6 marks)**

Required:

Advise the accountant on the matters set out above with reference to International Financial Reporting Standards.

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

(b) As a result of rising property prices, Kiki purchased five buildings during the current period in order to benefit from further capital appreciation. Kiki has never owned an investment property before. In accordance with IAS 40 *Investment Property*, the directors are aware that they can measure the buildings using either the fair value model or the cost model. However, they are concerned about the impact that this choice will have on the analysis of Kiki's financial performance, position and cash flows by current and potential investors.

Required:

Discuss the potential impact which this choice in accounting policy will have on investors' analysis of Kiki's financial statements. Your answer should refer to key financial ratios. (11 marks)

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

(Total: 25 marks)

Section 6

SPECIMEN 2 EXAM ANSWERS

1 HILL

(a) (i) Deferred consideration

When calculating goodwill, IFRS 3 *Business Combinations* states that purchase consideration should be measured at fair value. For deferred cash consideration, this will be the present value of the cash flows. This amounts to \$29 million (\$32m × 0.907). Goodwill arising on acquisition should be increased by \$29 million and a corresponding liability should be recognised:

Dr Goodwill	\$29 million
Cr Liability	\$29 million

Interest of \$1.5 million (\$29m × 5%) should be recorded. This is charged to the statement of profit or loss and increases the carrying amount of the liability:

Dr Finance costs	\$1.5 million
Cr Liability	\$1.5 million

Property, plant and equipment (PPE)

During the measurement period IFRS 3 states that adjustments should be made retrospectively if new information is determined about the value of consideration transferred, the subsidiary's identifiable net assets, or the non-controlling interest. The measurement period ends no later than 12 months after the acquisition date.

The survey detailed that Chandler's PPE was overvalued by \$10 million as at the acquisition date. It was received three months after the acquisition date and so this revised valuation was received during the measurement period. As such, goodwill at acquisition should be recalculated. As at the acquisition date, the carrying amount of PPE should be reduced by \$10 million and the carrying amount of goodwill increased by \$10 million:

Dr Goodwill	\$10 million
Cr PPE	\$10 million

NCI

The NCI at acquisition was valued at \$34 million but it should have been valued at \$32 million ((\$170m – \$10m PPE adjustment) × 20%). Both NCI at acquisition and goodwill at acquisition should be reduced by \$2 million:

Dr NCI	\$2 million
Cr Goodwill	\$2 million

Goodwill

Goodwill arising on the acquisition of Chandler should have been calculated as follows:

	$m
Fair value of consideration ($150m + $29m)	179
NCI at acquisition	32
Fair value of identifiable net assets acquired	(160)
Goodwill at acquisition	51

Goodwill impairment

According to IAS 36 *Impairment of Assets*, a cash generating unit to which goodwill is allocated should be tested for impairment annually by comparing its carrying amount to its recoverable amount. As goodwill has been calculated using the proportionate method, then this must be grossed up to include the goodwill attributable to the NCI.

	$m	$m
Goodwill	51	
Notional NCI ($51m × 20/80)	12.8	
Total notional goodwill		63.8
Net assets at reporting date:		
Fair value at start of period	160	
Profit for period	52	
		212
Total carrying amount of assets		275.8
Recoverable amount		(250.0)
Impairment		25.8

The impairment is allocated against the total notional goodwill. The NCI share of the goodwill has not been recognised in the consolidated financial statements and so the NCI share of the impairment is also not recognised. The impairment charged to profit or loss is therefore $20.6 million ($25.8m × 80%) and this expense is all attributable to the equity holders of the parent company.

Dr Operating expenses $20.6 million

Cr Goodwill $20.6 million

The carrying amount of the goodwill relating to Chandler at the reporting date will be $30.4 million ($51m acquisition –$20.6m impairment).

(ii) Doyle

The share sale results in Hill losing control over Doyle. The goodwill, net assets and NCI of Doyle must be derecognised from the consolidated statement of financial position. The difference between the proceeds from the disposal (including the fair value of the shares retained) and these amounts will give rise to a $47 million profit on disposal. This is calculated as follows:

	$m	$m
Proceeds		140
Fair value of remaining interest		300
		440
Goodwill at disposal		(50)
Net assets at disposal		(590)
NCI:		
At acquisition	215	
NCI % of post-acquisition profit (40% × ($590m – $510m))	32	
NCI at disposal		247
Profit on disposal		47

After the share sale, Hill owns 40% of Doyle's shares and has the ability to appoint two of the six members of Doyle's board of directors. IAS 28 *Investments in Associates and Joint Ventures* states that an associate is an entity over which an investor has significant influence. Significant influence is presumed when the investor has a shareholding of between 20 and 50%. Representation on the board of directors provides further evidence that significant influence exists.

Therefore, the remaining 40% shareholding in Doyle should be accounted for as an associate. It will be initially recognised at its fair value of $300 million and accounted for using the equity method. This means that the group recognises its share of the associate's profit after tax, which equates to $24.6 million ($123m × 6/12 × 40%). As at the reporting date, the associate will be carried at $324.6 million ($300m + $24.6m) in the consolidated statement of financial position.

(iii) Convertible bond

Hill has issued a compound instrument because the bond has characteristics of both a financial liability (an obligation to repay cash) and equity (an obligation to issue a fixed number of Hill's own shares). IAS 32 *Financial Instruments: Presentation* specifies that compound instruments must be split into:

– a liability component (the obligation to repay cash)

– an equity component (the obligation to issue a fixed number of shares).

The split of the liability component and the equity component at the issue date is calculated as follows:

– the liability component is the present value of the cash repayments, discounted using the market rate on non-convertible bonds

– the equity component is the difference between the cash received and the liability component at the issue date.

The initial carrying amount of the liability should have been measured at $17.9 million, calculated as follows:

Date	Cash flow	Discount rate	Present value
	$m		$m
30 September 20X6	0.8	0.909	0.73
30 September 20X7	20.8	0.826	17.18
			17.91

The equity component should have been initially measured at $2.1 million ($20m – $17.9m).

The adjustment required is:

Dr Non-current liabilities $2.1m

Cr Equity $2.1m

The equity component remains unchanged. After initial recognition, the liability is measured at amortised cost, as follows:

1 October 20X5	Finance charge (10%)	Cash paid	30 September 20X6
$m	$m	$m	$m
17.9	1.8	(0.8)	18.9

The finance cost recorded for the year was $0.8 million and so must be increased by $1.0 million ($1.8m – $0.8m).

Dr Finance costs $1.0m

Cr Non-current liabilities $1.0m

The liability has a carrying amount of $18.9 million as at the reporting date.

(b) Deferred tax

According to IAS 12 *Income Taxes*, an entity should recognise a deferred tax asset in respect of the carry-forward of unused tax losses to the extent that it is probable that future taxable profit will be available against which the losses can be utilised. IAS 12 stresses that the existence of unused losses is strong evidence that future taxable profit may not be available. For this reason, convincing evidence is required about the existence of future taxable profits.

IAS 12 says that entities should consider whether the tax losses result from identifiable causes which are unlikely to recur. Hill has now made losses in three consecutive financial years, and therefore significant doubt exists about the likelihood of future profits being generated.

Although Hill is forecasting an improvement in its trading performance, this is a result of new products which are currently under development. It will be difficult to reliably forecast the performance of these products. More emphasis should be placed on the performance of existing products and existing customers when assessing the likelihood of future trading profits.

Finally, Hill breached a bank loan covenant and some uncertainty exists 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.

Based on the above, it would seem that Hill is incorrect to recognise a deferred tax asset in respect of its unused tax losses.

Covenant breach

Hill is currently presenting the loan as a non-current liability. IAS 1 *Presentation of Financial Statements* states that a liability should be presented as current if the entity:

– settles it as part of its operating cycle, or

– is due to settle the liability within 12 months of the reporting date, or

– does not have an unconditional right to defer settlement for at least 12 months after the reporting date.

Hill breached the loan covenants before the reporting date but only received confirmation after the reporting date that the loan was not immediately repayable. As per IAS 10 *Events after the Reporting Period*, the bank confirmation is a non-adjusting event because, as at the reporting date, Hill did not have an unconditional right to defer settlement of the loan for at least 12 months. In the statement of financial position as at 30 September 20X6 the loan should be reclassified as a current liability.

Going concern

Although positive forecasts of future performance exist, management must consider whether the breach of the loan covenant and the recent trading losses place doubt on Hill's ability to continue as a going concern. If material uncertainties exist, then disclosures should be made in accordance with IAS 1.

Marking scheme

			Marks
(a)	(i)	Discussion 1 mark per point to a maximum	8
		Calculation	5
	(ii)	Discussion 1 mark per point to a maximum	3
		Calculation	4
	(iii)	1 mark for each point to a maximum	6
(b)	1 mark for each point to a maximum		9
Total			**35**

2 GUSTOSO

Provision

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that a provision should only be recognised if:

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

No provision should be recognised because Gustoso does not have an obligation to incur the training costs. The expenditure could be avoided by changing the nature of Gustoso's operations and so it has no present obligation for the future expenditure.

The provision should be derecognised. This will reduce liabilities by $2 million and increase profits by the same amount.

Contract

IFRS 9 *Financial Instruments* applies to contracts to buy or sell a non-financial item which are settled net in cash. Such contracts are usually 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. The contract will qualify as 'own use' because Gustoso always takes delivery of the wheat. This means that it falls outside IFRS 9 and so the recognition of a derivative is incorrect.

The contract is an executory contract. Executory contracts are not initially recognised in the financial statements unless they are onerous, in which case a provision is required. This particular contract is unlikely to be onerous because wheat prices may rise again. Moreover, the finished goods which the wheat forms a part of will be sold at a profit. As such, no provision is required. The contract will therefore remain unrecognised until Gustoso takes delivery of the wheat.

The derivative liability should be derecognised, meaning that profits will increase by $0.5 million.

Ethical implications

The users of Gustoso's financial statements, such as banks and shareholders, trust accountants and rely on them to faithfully represent the effects of a company's transactions. IAS 1 *Presentation of Financial Statements* makes it clear that this will be obtained when accounting standards are correctly applied.

Both of the errors made by Gustoso overstate liabilities and understate profits. It is possible that these are unintentional errors. However, incentives exist to depart from particular IFRS and IAS standards: most notably the bonus scheme. The bonus target in 20X7 has been exceeded, and so the finance director may be attempting to shift 'excess' profits into the next year in order to increase the chance of meeting 20X8's bonus target. In this respect, the finance director has a clear self-interest threat to objectivity and may be in breach of ACCA's *Code of Ethics and Conduct*.

The accountant is correct to challenge the finance director and has an ethical responsibility to do so. Despite the fact that the finance director is acting in an intimidating manner, the accountant should explain the technical issues to the director. If the director refuses to comply with accounting standards, then it would be appropriate to discuss the matter with other directors and to seek professional advice from ACCA. Legal advice should be considered if necessary. The accountant should keep a record of conversations and actions. Resignation should be considered if the matters cannot be satisfactorily resolved.

Marking scheme	
	Marks
Accounting issues – 1 mark per point up to maximum	6
Ethical issues – 1 mark per point up to maximum	7
Professional	2
Total	**15**

3 CALENDAR

(a) (i) Sale of intangible

IFRS 15 *Revenue from Contracts with Customers* defines revenue as income arising from an entity's ordinary activities. Calendar's ordinary activities do not involve selling development projects. In fact, Calendar has made no such sales since 20X0. It would seem that Calendar's business model instead involves developing products for its customers, who then take over its production, marketing and sale. Stage payments and royalties are the incomes which arise from Calendar's ordinary activities and should be treated as revenue.

Based on the above, Calendar is incorrect to recognise the gain as revenue. In fact, IAS 38 *Intangible Assets* explicitly prohibits the classification of a gain on derecognition of an intangible asset as revenue.

IAS 38 defines an intangible asset as an identifiable non-monetary asset without physical substance. Intangible assets held for sale in the ordinary course of business are outside the scope of IAS 38 and are instead accounted for in accordance with IAS 2 *Inventories*. The fact that the development project was classified as an intangible asset upon initial recognition further suggests that it was not held for sale in the ordinary course of business.

If the development was incorrectly categorised in the prior year financial statements as an intangible asset, then, as per IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* this should be corrected retrospectively. However, based on the infrequency of such sales, it seems unlikely that the development was misclassified.

(ii) Contract

IFRS 16 *Leases* says that a contract contains a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. When deciding if a contract involves the right to control an asset, the customer must assess whether they have:

– The right to substantially all of the identified asset's economic benefits

– The right to direct the asset's use.

Calendar has the right to use a specified aircraft for three years in exchange for annual payments. Although Diary can substitute the aircraft for an alternative, the costs of doing so would be prohibitive because of the strict specifications outlined in the contract.

Calendar appears to have control over the aircraft during the three-year period because no other parties can use the aircraft during this time, and Calendar makes key decisions about the aircraft's destinations and the cargo and passengers which it transports. There are some legal and contractual restrictions which limit the aircraft's use. These protective rights define the scope of Calendar's right of use but do not prevent it from having the right to direct the use of the aircraft.

Based on the above, the contract contains a lease. IFRS 16 permits exemptions for leases of less than 12 months or leases of low value. However, this lease contract is for three years, so is not short term, and is for a high value asset so a lease liability should have been recognised at contract inception. The lease liability should equal the present value of the payments yet to be made, using the discount rate implicit in the lease. A finance cost accrues over the year, which is charged to profit or loss and added to the carrying amount of the lease liability. The year-end cash payment should be removed from profit or loss and deducted from the carrying amount of the liability.

A right-of-use asset should have been recognised at the contract inception at an amount equal to the initial value of the lease liability plus the initial costs to Calendar of negotiating the lease. The right-of-use asset should be depreciated over the lease term of three years and so one year's depreciation should be charged to profit or loss.

(b) Materiality

Calendar's financial statements should help investors, lenders and other creditors to make economic decisions about providing it with resources. An item is material if its omission or misstatement might influence the economic decisions of the users of the financial statements. Materiality is not a purely quantitative consideration; an item can be material if it triggers non-compliance with laws and regulations, or bank covenants. Calendar should consider materiality throughout the process of preparing its financial statements to ensure that relevant information is not omitted, misstated or obscured.

Property, plant and equipment (PPE)

IAS 16 *Property, Plant and Equipment* states that expenditure on PPE should be recognised as an asset and initially measured at the cost of purchase. Writing off such expenditure to profit or loss is therefore not in accordance with IAS 16.

According to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* financial statements do not comply with International Financial Reporting Standards if they contain material errors, or errors made intentionally in order to present the entity's financial performance and position in a particular way. However, assuming that the aggregate impact of writing off small PPE purchases to profit or loss is not material, then the financial statements would still comply with International Financial Reporting Standards. Moreover, this decision seems to be a practical expedient which will reduce the time and cost involved in producing financial statements, rather than a decision made to achieve a particular financial statement presentation.

If implemented, this policy must be regularly reassessed to ensure that PPE and the statement of profit or loss are not materially misstated.

Disclosure notes

IAS 1 *Presentation of Financial Statements* states that application of IFRS Standards in an entity's financial statements will result in a fair presentation. As such, the use of a checklist may help to ensure that all disclosure requirements within IFRS Standards are fulfilled. However, IAS 1 and the Practice Statement *Making Materiality Judgements* both specify that the disclosures required by IFRS Standards are only required if the information presented is material.

The aim of disclosure notes is to further explain items included in the primary financial statements as well as unrecognised items (such as contingent liabilities) and other events which might influence the decisions of financial statement users (such as events after the reporting period). As such, Calendar should exercise judgement about the disclosures which it prepares, taking into account the information needs of its specific stakeholders. This is because the disclosure of immaterial information clutters the financial statements and makes relevant information harder to find.

Calendar may also need to disclose information in addition to that specified in IFRS Standards if relevant to helping users understand its financial statements.

Marking scheme			
			Marks
(a)	(i)	1 mark per point up to maximum	6
	(ii)	1 mark per point up to maximum	9
(b)	1 mark per point up to maximum		10
Total			**25**

4 KIKI

(a) (i) Gift cards

IFRS 15 *Revenue from Contracts with Customers* says that revenue should be recognised when or as a performance obligation is satisfied by transferring the promised good or service to the customer. When a customer buys a gift card they are pre-paying for a product. Revenue cannot be recognised because the entity has not yet transferred control over an asset and so has not satisfied a performance obligation. As such, cash received in respect of gift cards should be initially recognised as a contract liability.

IFRS 15 refers to a customer's unexercised rights as breakage. The guidance for variable consideration is followed when estimating breakage. In other words, the expected breakage is included in the transaction price if it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur once the uncertainty is subsequently resolved. This means that if the company is unable to reliably estimate the breakage amount, then revenue for the unused portion of the gift card is recognised when the likelihood of the customer exercising their remaining rights becomes remote. However, if an entity is able to reliably estimate the breakage amount, then it recognises the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer.

In relation to Kiki, it appears that the amount of breakage can be reliably determined and so this should be recognised in revenue as the gift card is redeemed. For every \$1 redeemed, Kiki should recognise \$1.43 (\$1 × 100/70) in revenue.

(ii) Royalty

According to IFRS 15, an entity should only account for revenue from a contract with a customer when it meets the following criteria:

– The contract has been approved

– Rights regarding goods and services can be identified

– Payment terms can be identified

– It is probable the seller will collect the consideration it is entitled to.

At inception of the agreement, Kiki and Colour entered an explicit contract which specified payment terms and conditions. Moreover, Colour had a strong credit rating and so payment was probable. As such, it would seem that the above criteria were met. IFRS 15 says that revenue from a usage-based royalty should be recognised as the usage occurs.

Whether a contract with a customer meets the above criteria is only reassessed if there is a significant change in facts and circumstances. In July 20X7, Colour lost major customers and sources of finance. As such, it was no longer probable that Kiki would collect the consideration it was entitled to. From July 20X7, no further revenue from the contract should be recognised.

According to IFRS 9 *Financial Instruments*, non-payment is an indicator that the outstanding receivables are credit impaired. A loss allowance should be recognised equivalent to the difference between the gross carrying amount of the receivables and the present value of the expected future cash flows receivable from Colour. Any increase or decrease in the loss allowance is charged to profit or loss.

(b) Investment properties

In accordance with IAS 40 *Investment Properties,* the buildings should be initially measured at cost.

If the cost model is applied, then the buildings will be measured at cost less accumulated depreciation and impairment losses.

If the fair value model is applied, then the buildings will be remeasured to fair value at each reporting date. Gains and losses on remeasurement are recognised in the statement of profit or loss. No depreciation is charged.

Statement of financial position

Assuming that property prices rise, the fair value model will lead to an increase in reported assets on the statement of financial position. In contrast, investment property measured using the cost model is depreciated, which reduces its carrying amount. This means that the fair value model may make Kiki appear more asset-rich. Some stakeholders may place importance on an entity’s asset base, as it can be used as security for obtaining new finance. Moreover investors would expect that the carrying amount of the asset will be recovered in the form of future cash flows, whether directly or indirectly.

As such, a higher carrying amount may increase investor optimism about future returns. However, reporting higher assets can sometimes be perceived negatively. For example, asset turnover ratios will deteriorate, and so Kiki may appear less efficient.

If assets increase, then equity also increases. As such, the fair value model may lead to Kiki reporting a more optimistic gearing ratio. This may reduce the perception of risk, encouraging further investment.

Statement of profit or loss

In times of rising prices, the use of the fair value model will lead to gains being reported in the statement of profit or loss. This will increase profits for the period. In contrast, the depreciation charged under the cost model will reduce profits for the period. Therefore, earnings per share, a key stock market and investor ratio, is likely to be higher if the fair value model is adopted.

However, it should be noted that fair values are volatile. In some years, fair value gains may be much larger than in other years. If property prices decline, then the fair value model will result in losses. As such, reported profits are subject to more volatility if the fair value model is adopted. This may increase stakeholders' perception of risk because it becomes harder to predict future profits. In contrast, the depreciation expense recorded in accordance with the cost model will be much more predictable, meaning that investors will be better able to predict Kiki's future results.

Many entities now present alternative performance measures (APMs), such as EBITDA (earnings before interest, tax, depreciation and amortisation). Other entities present 'underlying profit' indicators, which strip out the impact of non-operating or non-recurring gains or losses (such as the remeasurement of investment properties). Although the use of APMs has been criticised, Kiki may consider them to be useful in helping investors to assess underlying business performance through the eyes of management and to eliminate the impact of certain accounting policy choices.

Statement of cash flows

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

Disclosure

It should be noted that entities using the cost model for investment properties are required to disclose the fair value. Such disclosures enable better comparisons to be drawn between entities which account for investment property under different models.

Marking scheme			
			Marks
(a)	(i)	1 mark per point up to maximum	6
	(ii)	1 mark per point up to maximum	6
(b)	1 mark per point up to maximum		11
	Professional		2
Total			**25**

Section 7

REFERENCES

This document references IFRS Standards and IAS Standards, which are authored by the International Accounting Standards Board (the Board), and published in the 2022 IFRS Standards Red Book.

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