1 Luna Co - revised question

Luna Co is the parent company of a group that operates in the pharmaceutical industry. All entities in the group have a financial year end of 31 March. The current year end is 31 March 20X6.

The following **exhibits** provide information relevant to the question:

(1) Sale of shares in Starlight Co – provides information regarding a disposal of shares by Luna Co in Starlight Co during the year ended 31 March 20X6.

(2) Sale of goods to Starlight Co – provides information regarding a sale of goods between Luna Co and Starlight Co shortly before the reporting date.

(3) Roquet Co – provides information about the creation of Roquet Co including details of a sale of property from Luna Co to Roquet Co.

(4) Draft consolidated SOPL/SOFP – contains a draft consolidated statement of profit or loss (SOPL) for the year ended 31 March 20X6 and an extract of the draft consolidated statement of financial position (SOFP) as 31 March 20X6 (spreadsheet).

This information should be used to answer the question **requirements** within your chosen **response option(s)**.

Required

(a) (i) Using exhibit 1, explain, with calculations, how the disposal of shares in Starlight Co should be accounted for in the consolidated financial statements of the Luna group for the year ended 31 March 20X6. **(6 marks)**

(ii) Using exhibit 2, discuss the principles that should be considered by Luna Co in recording the sale of the goods to Starlight Co in Luna Co's INDIVIDUAL financial statements for the year ended 31 March 20X6. Conclude on whether the accounting treatment currently adopted is correct. **(6 marks)**

(b) Using exhibit 3, discuss, with calculations, how the investment in Roquet Co and the sale of the property should be accounted for in the consolidated financial statements of the Luna group in the year ended 31 March 20X6. **(6 marks)**

(c) Using the pre-populated spreadsheet response option along with the information in exhibits 1, 2 and 3, and your answers to parts (a) and (b), adjust the spreadsheet prepared by the directors of Luna Co in order to:

(1) Prepare a revised consolidated statement of profit or loss of the Luna Group for the year ended 31 March 20X6; and

(2) Prepare an extract of the consolidated statement of financial position of the Luna Group as at 31 March 20X6, showing retained earnings and non-controlling interests only.

The spreadsheet should take into account the following:

- Any adjustments required as a result of the sales of Product A1
- The profit attributable to the non-controlling interest and the owners of the parent
- The accounting treatment required for Roquet Co
- The disposal of the shares in Starlight Co

(12 marks)

(Total = 30 marks)

Exhibit 1: Sale of shares in Starlight Co

Luna Co acquired its 80% equity interest in Starlight Co on 1 April 20X2. Starlight Co had in issue 1,000,000 ($1) equity shares and has not issued any shares for many years. Goodwill on acquisition was correctly calculated as $320,000 but had subsequently been impaired by 15% in 20X4. Luna Co values the non-controlling interest at fair value. The fair value of the net assets of Starlight Co at acquisition exceeded their carrying amount by $200,000. This all related to non-depreciable land which is still owned by Starlight Co at 31 March 20X6.

On 1 January 20X6, Luna Co sold 100,000 equity shares in Starlight Co for $7 a share. The only reserve within equity in the individual statement of financial position of Starlight Co is retained earnings. The balance of this reserve at 1 April 20X5 was $4,658,000. Starlight Co generated a profit for the year ended 31 March 20X6 of $165,056 which accrued evenly throughout the year.

Exhibit 2: Sale of goods to Starlight Co

On 20 March 20X6, Luna Co sold 5,000 units of Product A1 to Starlight Co at an initial transaction price of $200 per unit and control of the goods passed from Luna Co to Starlight Co on that date. Payment is only due when Starlight Co sells the goods on to the end consumer which typically takes around six months. Starlight Co had not yet sold any of the goods on to the final consumer as at 31 March 20X6.

Product A1 has a high risk of obsolescence and therefore price concessions are regularly granted in order that the goods can be easily transferred on within the distribution channel. On the basis of past practice, Luna Co anticipates that it will grant Starlight Co a price concession of between 8% and 38%. Current market data suggests that a maximum price concession of 35% may be necessary to enable Starlight Co to distribute the goods to the final consumer.

The initial cost of Product A1 to Luna Co was $80 per unit. Luna Co has recorded the sale at the initial transaction price of $200 per unit. Starlight Co has included the goods within its closing inventory at a value of $1,000,000.

The directors of Luna Co have prepared a draft consolidated statement of profit or loss for the Luna Group for the year ended 31 March 20X6 (exhibit 4). The revenue and costs of Starlight Co for the year have been included in the draft statement of profit or loss on a line by line basis, but no adjustments to the consolidated financial statements have been made in respect of the sales of Product A1.

The directors of Luna Co have not yet prepared the equity section of the consolidated statement of financial position for the Luna Group as at 31 March 20X6. An extract showing the retained earnings and non-controlling interests balances is provided in the spreadsheet in exhibit 4. The directors of Luna Co have simply included the brought forward balances on retained earnings and non-controlling interests at 1 April 20X5, and have not yet made any adjustments to these amounts to take into account the profit for the year or any other adjustments.

Exhibit 3: Roquet Co

On 1 April 20X4, Luna Co and an unconnected third party established a joint arrangement involving the creation of a joint venture, Roquet Co. Each venturer paid $6 million in cash to the newly created entity, Roquet Co, in exchange for a 50% interest in the equity shares.

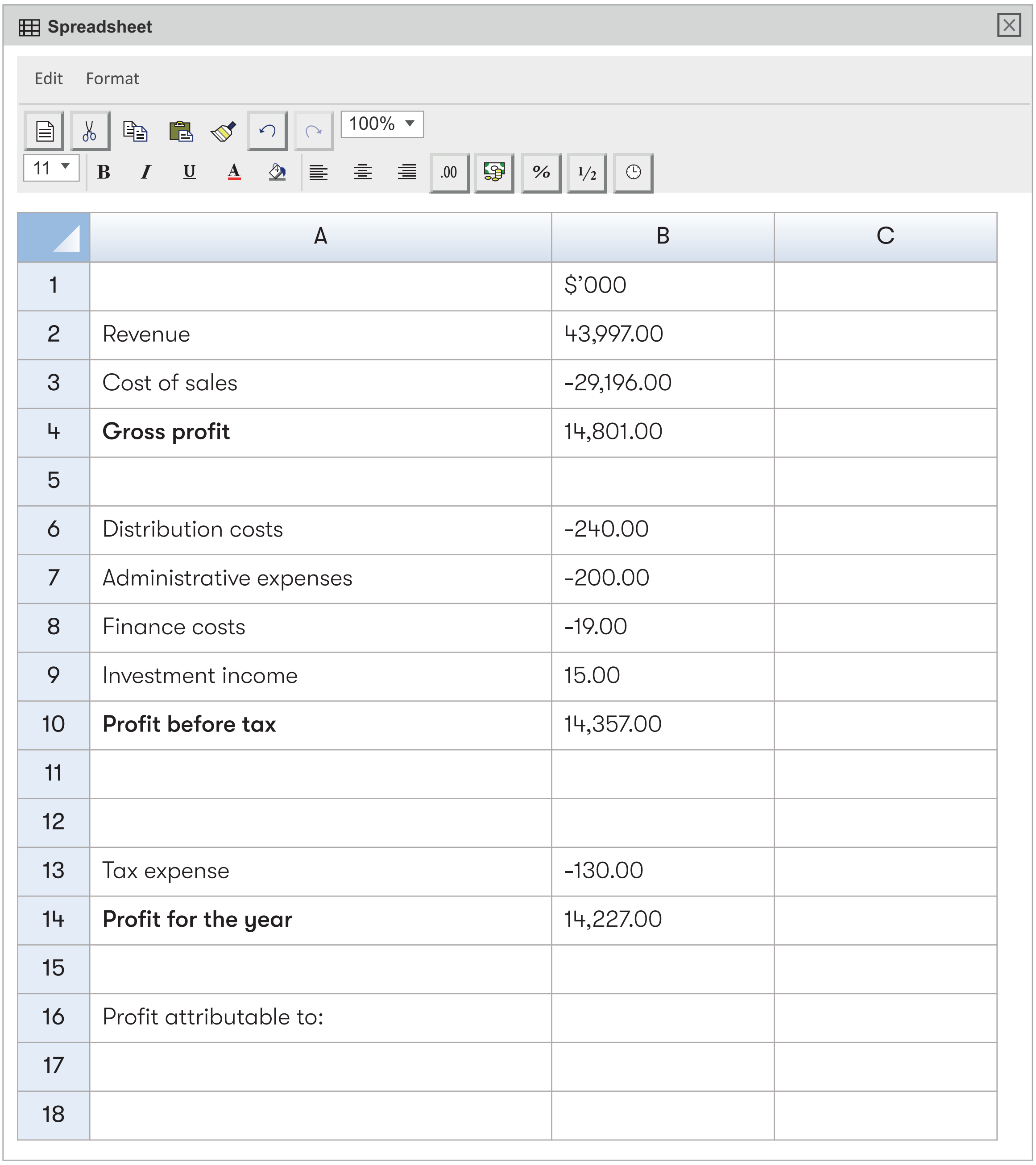
Roquet Co has earned profits for the year of $73,450 and $126,980 in the years ended 31 March 20X5 and 31 March 20X6 respectively. Additionally, Roquet Co paid dividends to both Luna Co and the other venturer of $15,000 each in the current year. This was the first time Roquet Co had paid dividends to its investors.

On 31 March 20X6, Luna Co transferred a property to Roquet Co for proceeds of $8 million which is agreed to be equal to the market value of the property on that date. The carrying amount of the property in the financial statements of Luna Co at this date was $10 million.

The only entry related to Roquet Co that the directors have made in the draft consolidated statement of profit or loss for the year ended 31 March 20X6 (exhibit 4) was to include the $15,000 dividend received from Roquet Co in investment income.

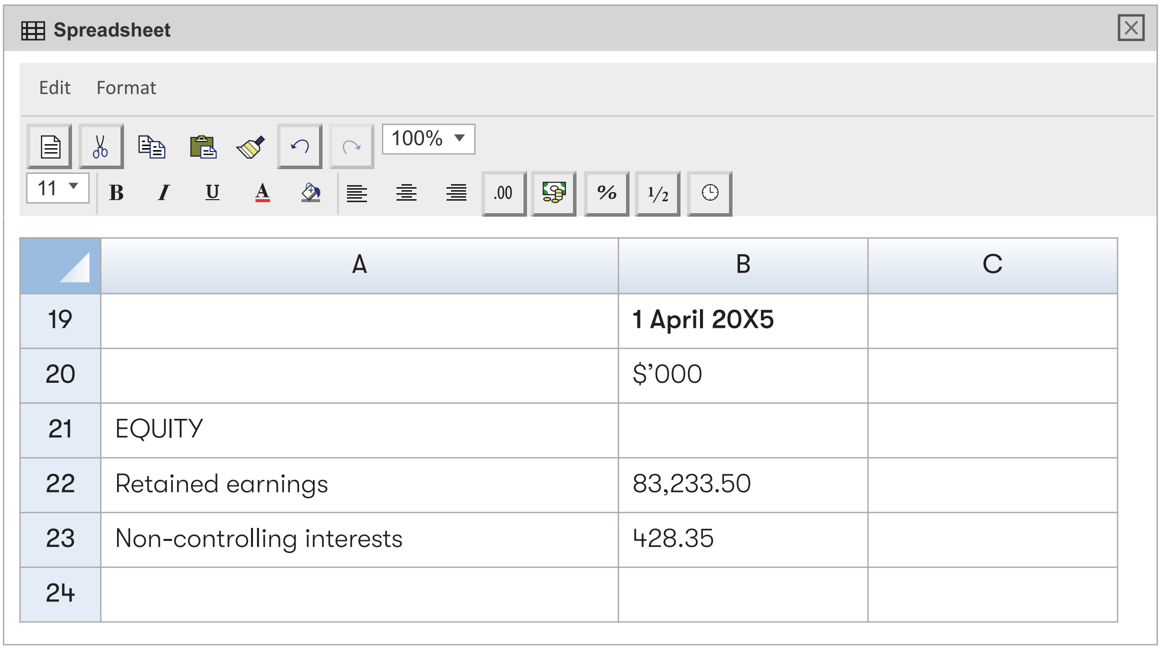
Exhibit 4: Draft consolidated SOPL/SOFP

Draft consolidated statement of profit or loss for the year ended 31 March 20X6



	A	B	C
1		$'000	
2	Revenue	43,997.00	
3	Cost of sales	-29,196.00	
4	**Gross profit**	14,801.00	
5			
6	Distribution costs	-240.00	
7	Administrative expenses	-200.00	
8	Finance costs	-19.00	
9	Investment income	15.00	
10	**Profit before tax**	14,357.00	
11			
12			
13	Tax expense	-130.00	
14	**Profit for the year**	14,227.00	
15			
16	Profit attributable to:		
17			
18			

Draft consolidated statement of financial position as at 31 March 20X6 (extract)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	A	B	C
19		**1 April 20X5**	
20		$'000	
21	EQUITY		
22	Retained earnings	83,233.50	
23	Non-controlling interests	428.35	
24			

1 Luna Co - revised answer

Marking guide		Marks	
(a) (i)	1 mark per discussion point of key principles in IFRS 3 and application to the scenario (max 3 marks), including:	3	
	– No loss of control		
	– Consolidation all year		
	– Equity transaction		
	– No gain/loss reported in profit or loss		
	– Consider how to treat goodwill		
	Marks for calculations as follows (1 mark for each, max 3):	3	
	– 9/12 profit added		
	– Goodwill less impairment		
	– Fair value adjustment of land		
	– 10% of net assets to NCI		
	– Gain to equity		
			6
(ii)	1 mark per discussion point of key principles in IFRS 15 and application to the scenario, including:		
	Timing of revenue recognition	1	
	Other points, max 3 marks:	3	
	- Variable consideration		
	- Estimate needed		
	- Expected value or most likely outcome		
	- Consider if reversal likely		
	- Historic concessions		
	Conclusion	1	
	Calculations	1	
			6
(b)	1 mark per discussion point of key principles in IAS 28 and application to the scenario, including:		
	Explanation of equity method/Exclude dividend received	2	
	Property disposal/No need to eliminate intra-group/Impairment indicator	2	
	Calculations/Share of profits of JV/Investment in JV/Dividend adj	2	
			6
(c)	Spreadsheet:		
	Unrealised profit calculation	1	
	Profit attributable to NCI/Parent	2	
	Adjustments to SOPL	5	
	Adjustments to SOFP	4	
			12
Total			30

(a) (i) The disposal of 100,000 shares by Luna Co would reduce its equity interest from 80% to 70%. This would not result in a loss of control over Starlight Co. Income and expenses should be consolidated for the entire year. Similarly, the disposal does not affect the consolidation of Starlight's assets and liabilities, including goodwill.

A decrease in the parent's ownership interest which does not result in a loss of control is accounted for as an equity transaction, i.e. a transaction with owners in their capacity as owners. The carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary. Luna Co should recognise directly in equity any difference between the amount which the non-controlling interest is adjusted by and the fair value of the consideration received. No gain or loss on the disposal of the shares should be recognised within profit or loss.

It is not clear under IFRS 10 *Consolidated Financial Statements* as to what happens to the non-controlling interests' share of goodwill when there is a change in the relative ownership of a subsidiary. However, it seems reasonable that Luna Co should reallocate 10% of the carrying amount of goodwill to the non-controlling interest. This will ensure that future impairments of goodwill will reflect the revised ownership interest in the goodwill.

The net assets of Starlight Co at 1 January 20X6 should be determined as follows:

	$
Share capital	1,000,000
Retained earnings at 1 April 20X5	4,658,000
Add 9 months of profit to the disposal date (9/12 x $165,056)	123,792
Fair value adjustment on land	200,000
Carrying amount of goodwill ($320,000 x 85%)	272,000
Net assets at 1 January 20X6	6,253,792

Since the non-controlling interest is obtaining an extra 10% of the equity of Starlight Co, the non-controlling interest in the consolidated statement of financial position will be credited with $625,379 (10% x $6,253,792). The fair value of the consideration received is $700,000 (100,000 x $7). Luna Co should record a credit directly in equity equal to the difference of $74,621 ($700,000 – $625,379).

Dr Cash	$700,000	
Cr NCI		$625,379
Cr Equity		$74,621

> **Tutorial note.** *A different acceptable approach would be to calculate the non-controlling interest at the date of disposal and then to increase non-controlling interest by 10/20 to reflect their increased ownership interest in Starlight Co. However, this cannot be calculated as the non-controlling interest at acquisition is not given in the question.*

(ii) Revenue should be recognised when a performance obligation is satisfied. This can be over time or at a point in time. Since the risks and rewards of ownership of Product A1 passes to Starlight Co on 20 March 20X6, it is right that Luna Co should recognise revenue at this date and not when Starlight sells the goods to the final consumer.

The price concession which is likely to be offered by Luna Co means that the value of the consideration is variable and uncertain. IFRS 15 *Revenue from Contracts with Customers* requires the entity to estimate the amount of consideration to which it is entitled in exchange for the goods sold. Luna Co should either choose an expected value method or choose the most likely outcome to estimate the amount of the variable consideration.

Luna Co should choose whichever method will better predict the amount of the consideration to which it is entitled.

Since Luna Co has a history of offering price concessions but over a range from 8% to 38%, it would appear that an expected value method is probably more appropriate. In the absence of further information, it would seem reasonable to make an initial estimate of the variable consideration by using the mid-point of the previous price concessions. This would be a price concession equal to 23%. This would result in a revenue figure equal to $770,000 ($200 x 5,000 x 77%).

IFRS 15 states that when estimating the amount of variable consideration, revenue must only be recognised to the extent that it is highly probable that a significant reversal of the cumulative revenue will not be required in the future. The risk of obsolescence means that the value of the consideration Luna Co is entitled to is highly contingent on factors outside the control of Luna Co. Luna Co has a history of offering price concessions of up to 38%, so it is unlikely that Luna Co can conclude that it is highly probable that a significant reversal in revenue will not be required. Current market data suggests that the maximum price concession is likely to be 35%. Therefore, it seems reasonable for Luna Co to revise its estimate to $650,000 ($200 x 5,000 x 65%). This is the maximum that it is highly probable that a significant reversal of revenue will not be required. Since the whole $1,000,000 ($200 x 5,000) has been included within revenue, the accounting treatment adopted is not correct. Revenue should be reduced by $350,000 ($1,000,000 – $650,000).

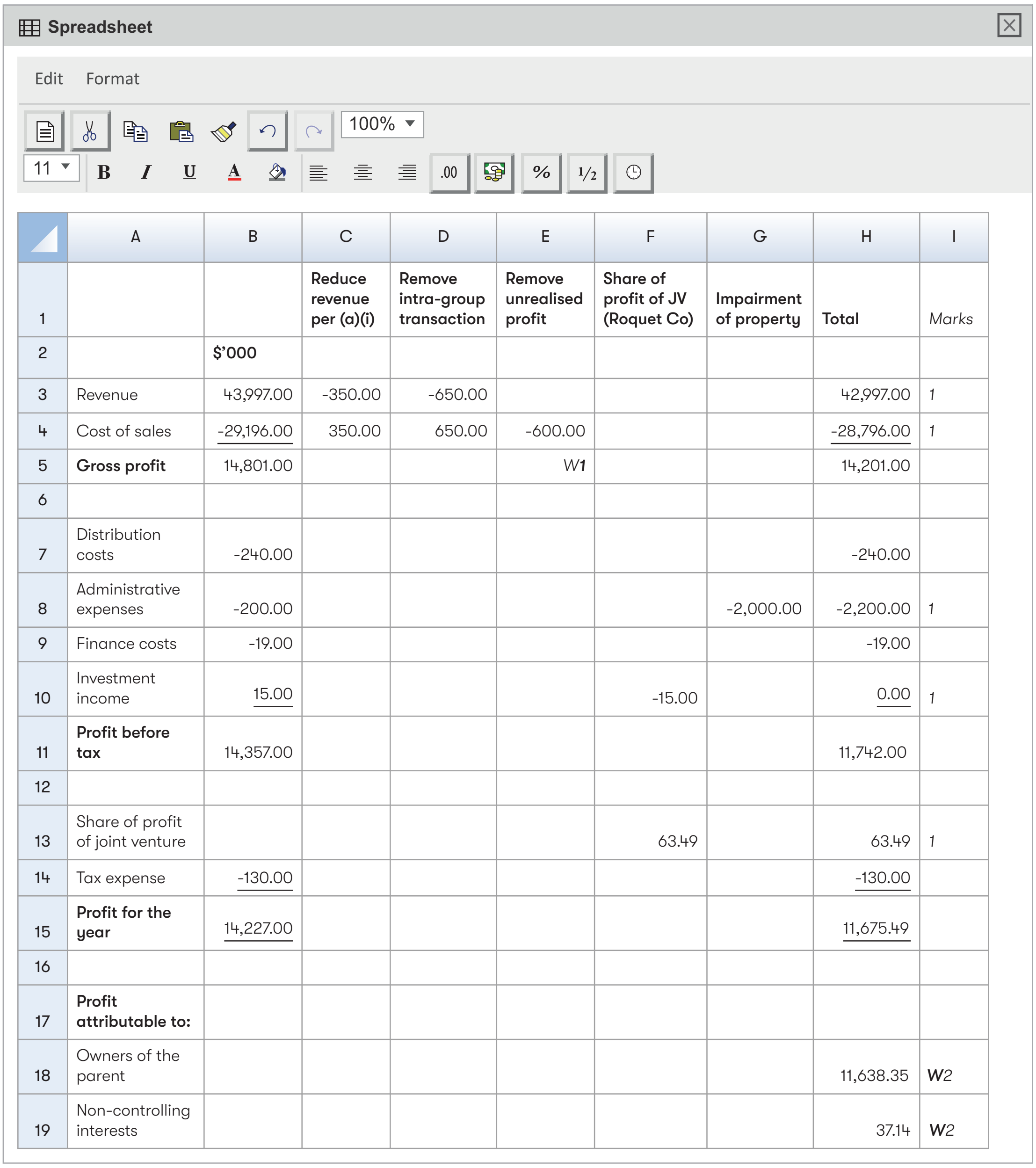
Tutorial note. *Candidates are given full credit for different assumptions on the price concession provided that they are justified in their answer.*

(b) In accordance with IAS 28 *Investments in Associates and Joint Ventures*, Luna Co should adopt equity accounting within its consolidated financial statements for its investment in Roquet Co. This means that in the consolidated statement of financial position the investment should be included as one figure within non-current assets (an investment in joint venture). This is initially recognised at cost but will be increased by its 50% equity interest in the increase in net assets since incorporation. Within the consolidated statement of profit or loss, 50% of the profit for the year of Roquet Co will need to be included as a one line item. Since the profit is before deducting any dividend payments during the year, it is important to exclude the $15,000 dividend received by Luna Co from investment income within the consolidated statement of profit or loss.

The share of the profits of the joint venture for the year ended 31 March 20X6 should be calculated as $63,490 (50% x $126,980). Since Luna Co received a dividend of $15,000, total dividends paid by Roquet Co would have been $30,000 ($15,000/0·5). This means that the net assets of Roquet Co would have increased since incorporation by $170,430 ($73,450 + $126,980 – $30,000). The investment in the joint venture in the consolidated statement of financial position should be valued at $6,085,215 ($6,000,000 + (50% x $170,430)).

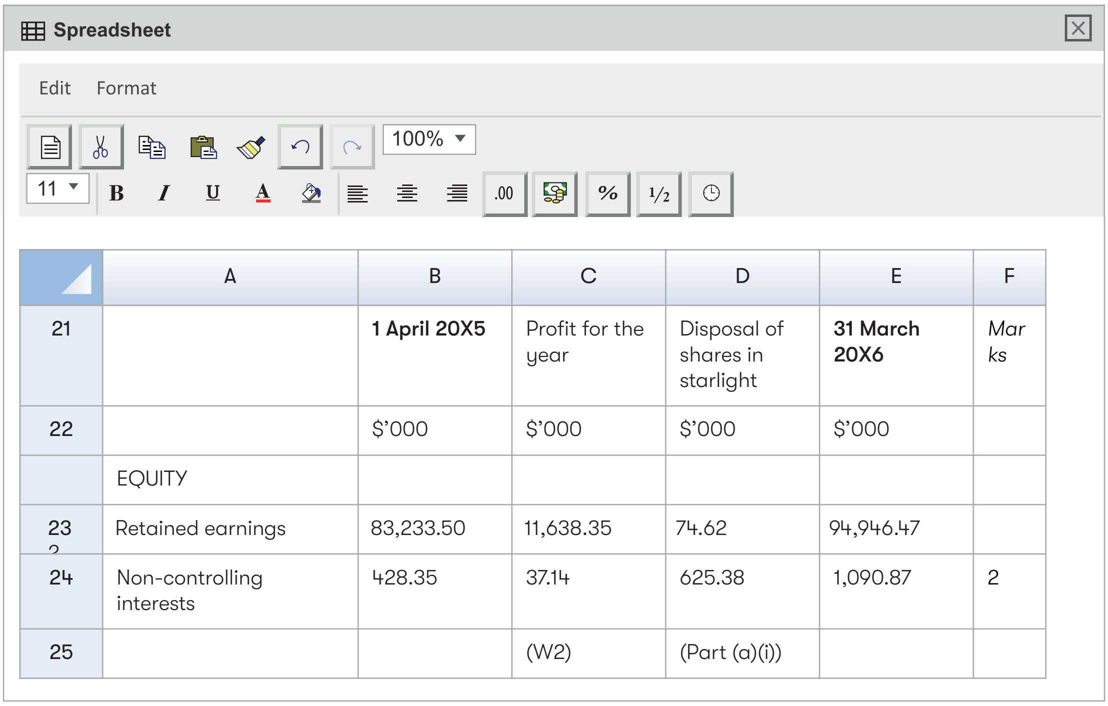
The joint venture is not part of the single entity concept and therefore it is not necessary to eliminate transactions and outstanding balances at the reporting date between the parent and the joint venture. However, IAS 28 does require that gains and losses arising between a parent entity and its joint venture should only be recognised to the extent of the unrelated investors' interest in the joint venture. An exception to this rule is that losses should be recognised in full by the parent where a downstream transaction provides evidence that the asset is impaired. This is relevant to Luna Co as they have sold the property to Roquet Co (a downstream transaction) at a loss of $2 million ($10 million – $8 million). Since it is agreed that the proceeds of $8 million are equal to the market value of the property, this provides evidence that the property was indeed impaired. Luna Co should recognise the loss of $2 million within its individual and consolidated financial statements for the year ended 31 March 20X6. The investment in the joint venture and the share of the profits of the joint venture will not be affected by the transaction.

(c) **Consolidated statement of profit or loss for the year ended 31 March 20X6**



	A	B	C	D	E	F	G	H	I
1			**Reduce revenue per (a)(i)**	**Remove intra-group transaction**	**Remove unrealised profit**	**Share of profit of JV (Roquet Co)**	**Impairment of property**	**Total**	*Marks*
2		**$'000**							
3	Revenue	43,997.00	-350.00	-650.00				42,997.00	*1*
4	Cost of sales	-29,196.00	350.00	650.00	-600.00			-28,796.00	*1*
5	**Gross profit**	14,801.00			*W1*			14,201.00	
6									
7	Distribution costs	-240.00						-240.00	
8	Administrative expenses	-200.00					-2,000.00	-2,200.00	*1*
9	Finance costs	-19.00						-19.00	
10	Investment income	15.00				-15.00		0.00	*1*
11	**Profit before tax**	14,357.00						11,742.00	
12									
13	Share of profit of joint venture					63.49		63.49	*1*
14	Tax expense	-130.00						-130.00	
15	**Profit for the year**	14,227.00						11,675.49	
16									
17	**Profit attributable to:**								
18	Owners of the parent							11,638.35	**W2**
19	Non-controlling interests							37.14	**W2**

Consolidated statement of financial position as at 31 March 20X6 (extract)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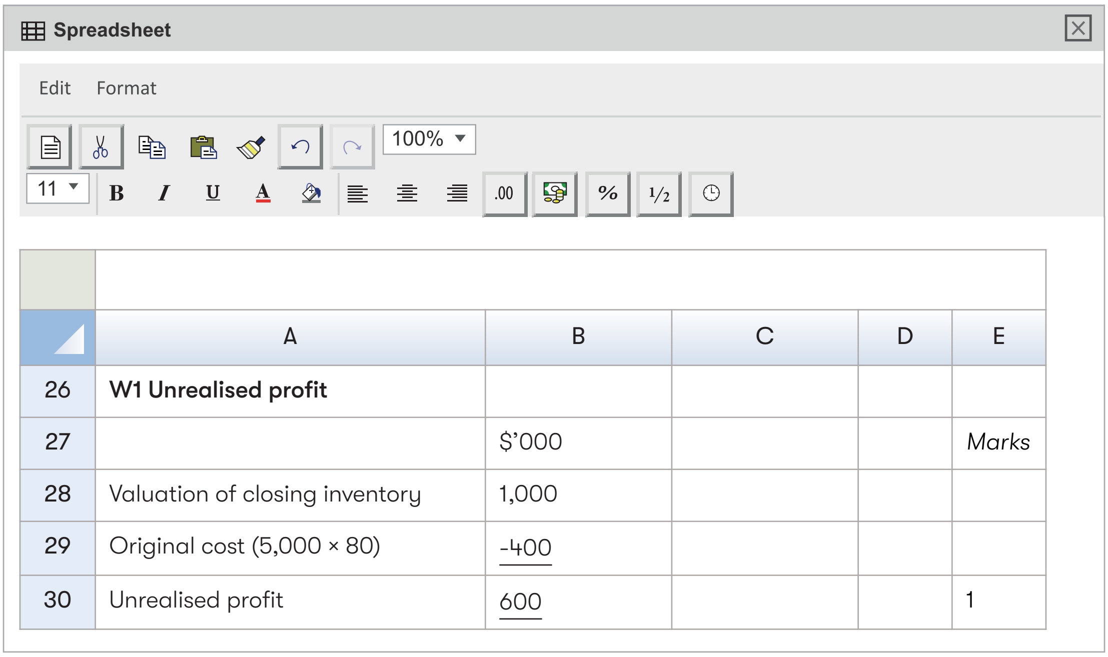
	A	B	C	D	E	F
21		**1 April 20X5**	Profit for the year	Disposal of shares in starlight	**31 March 20X6**	*Marks*
22		$'000	$'000	$'000	$'000	
	EQUITY					
23 2	Retained earnings	83,233.50	11,638.35	74.62	94,946.47	
24	Non-controlling interests	428.35	37.14	625.38	1,090.87	2
25			(W2)	(Part (a)(i))		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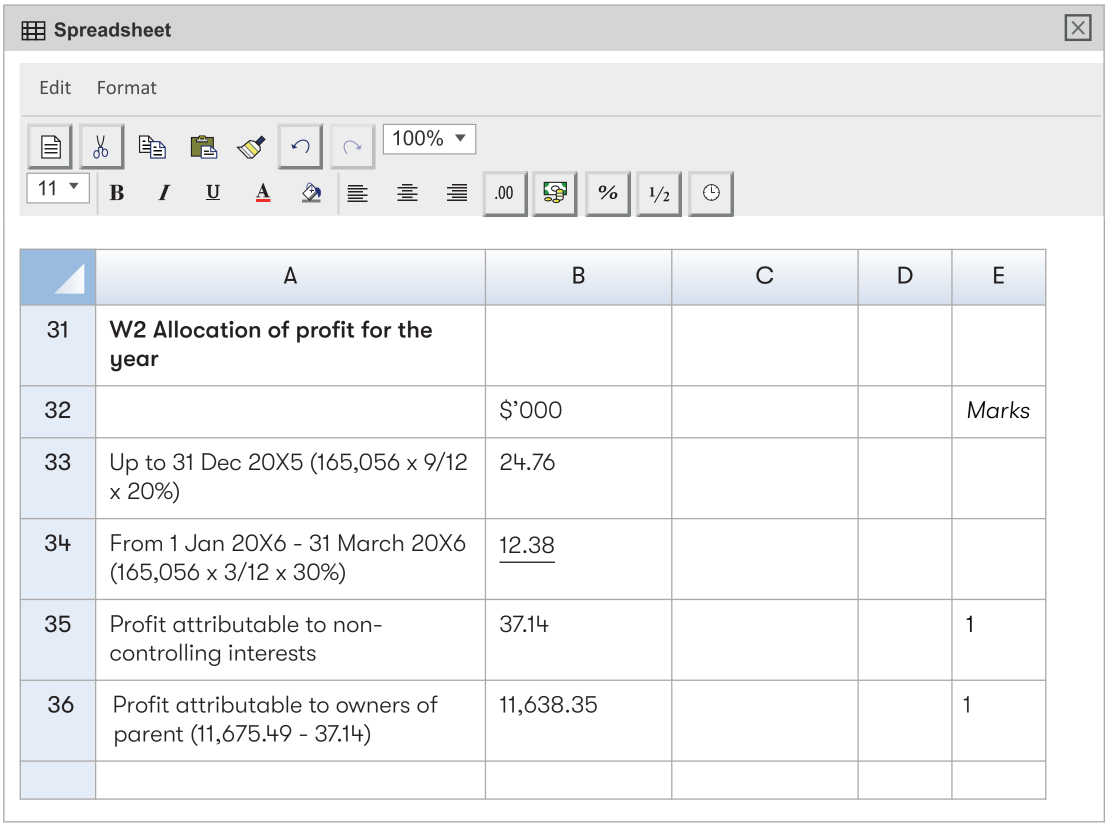
	A	B	C	D	E
26	**W1 Unrealised profit**				
27		$'000			*Marks*
28	Valuation of closing inventory	1,000			
29	Original cost (5,000 × 80)	-400			
30	Unrealised profit	600			1



	A	B	C	D	E
31	**W2 Allocation of profit for the year**				
32		$'000			*Marks*
33	Up to 31 Dec 20X5 (165,056 x 9/12 x 20%)	24.76			
34	From 1 Jan 20X6 - 31 March 20X6 (165,056 x 3/12 x 30%)	12.38			
35	Profit attributable to non-controlling interests	37.14			1
36	Profit attributable to owners of parent (11,675.49 - 37.14)	11,638.35			1