(b)(i) Methods

The two methods are simply two different ways of deriving cash generated from operations. They are different ways of laying out operating cash flow. The investing and financing sections are unaffected by the methods.

Direct method

The direct method is a method of calculating the operating cash flow that starts with the cash inflow from customers and simply lists all the operating cash outflows by class. The result is the readers can see how much operating cash flowed in and how much cash flowed out to suppliers, employees and other parts of operations. So the operating section of the cfs would look something like this:-

Cash from customers	x
Cash to suppliers	(x)
Cash to employees	(x)
Cash generated from operations	x

Name direct method

The direct method is so called because, in theory, it is derived directly from the cash records. But in reality those few companies that produce direct method cash flows do so indirectly from the i/s and b/s.

Example

For example, if Jocatt were to produce a direct cash flow it would start with the following:-

	$m
Cash inflow from customers	488
(sales + opening rec- closing rec + acq)	
(432+113-62+5)	

You can see that the above is very similar to what we did above on our indirect cash flow.

Comment on direct method

This presentation is natural and intuitive. It tells the reader how much cash flowed in and how much flowed out. It also has consistency (and cohesion) with the i/s. The i/s starts with sales to customers and a direct cfs starts with cash from those customers.

Indirect method

This is a method that calculates the operating cash flow by starting with the operating profit and then adding back non cash flow costs and adjusting for working capital. It is the method used in part(a) above.

Name indirect method

It is called the indirect method because it can only be calculated indirectly from the i/s and b/s and cannot be calculated directly from cash records.

Comment on indirect method

The indirect method is essentially just an accounting reconciliation. It does not actually show cash flows, which is bizarre when you think about it. It has its up sides; it does give a strong feel for working capital management. But really the only reason the method persists is because everybody does it.

Profit reversal

The IAS7 indirect method is even more difficult for readers to understand as it starts with pbt and reverses up to op, as you can see in the first few lines of my answer above.

Conclusion

The direct method is obviously the more intuitive method. It presents a cash flow statement by presenting cash flows. This is why the IASB propose to move to the direct method of cfs.

(b)(ii) Creative accounting

Fs are required to show a true and fair view. The directors are aware of this but want to manipulate the view in the fs to their own advantage.

Motivation

Their motivation is fairly obvious. They want to hit their operating cash flow target and get their bonus.

Ethics

Directors are required by law to look after shareholders interests. Clearly in this instance they are looking after their own interests to the direct detriment of shareholders. Their morality is selfish.

IAS7

The directors are trying to take advantage of IAS7. IAS7 is old and like a lot of old IFRS it is less than perfectly clear about where things should go. However, it is very clear that the cash inflow is from a loan and even IAS7 makes it clear that financing flows go into financing.

Audit

This is why the law requires an audit. An auditor would pick this up easily and would require a change in the fs. If directors refused to change the fs then a modification would follow and possibly the removal of the directors.

Development

The IASB are aware of the potential for creative accounting that takes advantage of the lack of clarity in IAS7. This is another reason that the cfs is under development.

Answer 55 Margie

Answer commentary

This is a practical question with four imaginary stories in which shares are involved. There are many different ways to interpret each story, lots of different suggestions that would solve the problems and an infinite number of things you could say about each. So do not try too hard to get an answer like mine or indeed like the examiner.

Simply endeavour to analyse the scenarios, pull out the salient points that you see in each and knock out the same number of points as there are marks for each story.

You can be confident that the answer below would score full marks. But so can you, with a very different answer.

(a) Share based payment

Share based payment is literal. It occurs when you use shares to buy stuff. There is the classic motivational sbp used extensively by quoted companies to lock in directors for a period using options. Then there is the much more rare swap of shares for assets, such as the building in question 2(c) below or the franchise right in question 3(c).

Margie contract as SBP

There is none of this in the Margie contract. The only thing passing between Margie and the wheat producer is cash. Margie is not buying wheat and Margie is not issuing shares.

Derivative

The contract is a derivative financial instrument. It derives its value from the price of wheat and Margie shares. As wheat prices and Margie share prices go up and down, so the amount we have to pay the other party goes up and down. Another name for derivative is bet. This is just a bet on the price of wheat and shares.

Fair value

Of course, derivatives are financial instruments and are carried at fair value with the gains and losses going into the income statement.

Measurement

The Margie derivative is complex. It is a bet on both wheat and share prices. So there may be a need to get a professional to measure the fair value.

Hedging

Hedging occurs when you have a primary risk (for example, a fear of wheat prices going up) and you use a derivative to bet against that risk (for example, by using a wheat derivative).

Margie contract as Hedging

There is none of that here. There is no evidence Margie has anything to do with wheat. And besides, the derivative is a bet on both wheat prices and Margie share prices, so the derivative would be useless as a hedge. Margie can forget about the hedging rules.

Effective hedge derivatives

Effective hedge derivatives move with just one thing. So a coffee derivative is good for coffee hedging and a chocolate derivative is good for chocolate hedging. A derivative that moves with both coffee prices and chocolate prices would be useless for hedging.

(b) Real life

In real life, acquirers insist that target companies tidy up their share structure prior to the acquisition. This is so that the acquirer can make a clean purchase of all the equity of the target in one go. Kaplan do this with their many worldwide acquisitions, but it is common in all industries.

Directors

This is why directors frequently get excited about the prospects of a takeover. It means that they will get to close out their sbp early when the target pays them off immediately before the acquirer acquires the target.

Margie Acquisition

Margie has foolishly not insisted on Antalya tidying up its sbp before acquisition and so has inherited the sbp obligation in the acquisition. This leads to messy negotiations and complex accounting.

Equity obligation

So Margie ended up paying off the $20m equity obligation during the acquisition. This payment is part of the consideration for the 100% ownership in Antalya.

Option swap

So Margie takes the Antalya options off the Antalya employees and gives the employees Margie options instead. It is a simple swap.

Valuations

But the strangeness continues as Margie take Antalya options apparently worth $20m and replace them with Margie options apparently worth $22m. It is very difficult to imagine a situation where both figures are right. It is most likely the $22m from the Margie options is the real value of the swap. After all, Margie is a public limited company and so its shares and maybe its options are quoted.

Conclusion

I suggest the consideration and new equity obligation are valued at $22m.

Alternative

If the two fair values are both right and Margie really has offered a new sbp that exceeds the value of the obligation, then the extra $2m would go into the income statement as a cost.

(c) Share issue

The share issue to shareholders appears to be a simple rights issue. The fact some of the shareholders happen to be employees is incidental. This would be accounted for as a simple share issue for cash.

Swap

The barter transaction of a building being bought with equity is yet another swap. This is share based payment (although nothing to do with the classic motivational sbp involving employees and a vesting period and all that).

Measurement

The figure that should be used for both the incoming building and the outgoing equity should be the more reliable figure, the figure most likely to reflect the true market value of the deal. It should not be too difficult as the value of the building and the value of the quoted share should be the same.

Related party transaction

This may be a related party transaction as Grief may have some influence over Margie via the 5% ownership (or maybe not, 5% is very low for influence). So I suggest an rpt disclosure is considered.

(d) Share price condition

The Margie share price condition is really tricky. It has two parts. First, the options only vest *if* the share price reaches $15. Then the options vest *when* the share price reaches $15. Very subtle.

Market conditions

IFRS2 requires we ignore share price conditions that say options only vest *if* the share price reaches a certain price. So we ignore the first component of the above.

Vesting period

But also IFRS2 requires that we estimate the duration of the vesting period. Normally this is obvious. It is usually fixed in the contract. But in this contract it is variable. So we are obliged to look into the second component of the share price condition.

Initial estimate

At the start of the deal we think the deal will run for 4 years. We think the share price will hit $15 on 30 November 2011. Obviously that is a complete guess. But there is nothing else

we can do. This guess does not change at the end of year one or year two. So at the end of year two and the start of the current year, we are at the 2/4 point in the deal.

Change in estimate

But at the end of year three, we get taken by surprise. The share price hits $15 and the options vest. So the deal turned out to be a three year deal and we are at the 3/3 point.

Equity obligation

So the numbers are like this for the current year:-

		$m
Opening	(100*4,000)$10(2/4)	2
Operating cost	(balance)	2
Closing	(100*4,000)$10(3/3)	4

Answer 56 Greenie

Answer commentary

This is a fairly typical industry mix question. Like all industry mix questions, the focus is upon analysis. The idea is to look at the stories, see the picture each paints and deliver the same number of points as there are marks in the story.

As with all industry mix questions, the examiner encourages you to draw your own conclusions. Time and time again, the examiner has allocated full marks to good student answers that recommend the opposite to the published answer or interpret the story entirely differently. The examiner wants you to delver your analysis, not his.

(a) Provisions

A provision is required if three criteria are fulfilled
R reasonably reliable estimate
O obligation
T transfer of economic benefit

Legal action

The scenario is difficult to interpret as it says "resulted in...legal action" then "no legal action has been brought". So I am going to have to guess as to whether Greenie have an obligation at the current year end.

Regulation

However, I do know that the air industry is highly regulated. It is likely that Greenie has breached contracts and regulations when the airport section collapsed. And so it is likely that Greenie has an obligation to pay compensation to the victims of the collapse even if legal action has yet to commence.

Conclusion

This seems to be supported by the scenario reference to "compensation agreements had been arranged with the victims". I therefore recommend that Greenie estimate the likely cash out flow and provide.

Politics

However, I also understand that to do this is highly political. It could be interpreted as an acknowledgement of responsibility. Perhaps Greenie should consider disclosure describing the case as ongoing and making it clear that at present Greenie do not accept any liability.

Insurance

The potential cash in flow appears to be a probable contingent asset. So this asset should be disclosed.

Contingent liability

There may also be a contingent liability to the airlines. Greenie may have to pay compensation to them for loss of earnings. This appears to be a possible contingent liability, so should be provided.

(b) Relationships

A parent accounts for entities in which it has equity ownership depending on the relationship with the entity. There are three relationships as follows:-

Relationship	*entity*	*accounting*
Control	subsidiary	consolidation (acquisition accounting)
Influence	associate	single line (equity accounting)
Passive	investment	investment (financial instrument)

Control

Control is defined as the power to direct activities. It is usually obtained by voting sufficient to pass resolutions.

Influence

Influence is defined as the power to participate in decisions. It is also usually obtained by voting and is presumed at 20%.

Shareholders agreement

But the relationships in Manair are more to do with the shareholders agreement than the percentages of ownership. The scenario does tell us that some decisions require a unanimous vote and other decisions require a majority. But the scenario does not tell us which decisions.

Representation

We know that Greenie has two of the ten directors on the board. So, if all decisions require a unanimous vote then Greenie would have influence and an associate. Or even if the majority six listened to the Greenie two when setting strategy, then Greenie would have influence.

Related party transaction

This would make the maintenance contract an rpt and so the maintenance contract would be disclosed.

Minority protection

However, it is possible that a unanimous decision is required for the issue of shares and such like. This is to give the minority protection against dilution. But it is possible that the day to day decisions require a simple majority.

Strategy

If the above is correct, then the majority shareholder would have the power to set Manair strategy. So they may direct the majority six to ignore the Greenie two. This is in fact quite common in real life and happened to Singapore airlines when then held a massive 49% of Virgin Blue but were cut out by Virgin who held 51%.

Greenie

If the above is correct, then it is likely majority shareholder would not listen to the other two shareholders. So Greenie would have no say in any strategic decision and without influence Greenie would not have an associate.

Strategic equity investment

So the equity would be carried at fair value and, if the equity is held with strategic intent, then the gains and losses would be recognised in the oci.

(c) Barter share based payment

This swap of shares for a franchise right is a barter transaction. It is a transaction that is not settled in cash. The rules on barter transactions are less than perfect but essentially both the outgoing and incoming component should be valued. Then the figure most likely to represent true market value is used for the swap.

IFRS2 Share based payment and IAS18 Revenue

Both the above agree on this use of the more reliable valuation. But IFRS2 goes a little further. IFRS2 says the valuation should be based on the incoming asset unless that is unreliable in which case the outgoing equity valuation should be used. All very messy, but essentially that means the more reliable estimate of market valuation should be used for the swap with a leaning towards the incoming asset valuation.

Greenie swap

The franchise valuer came up with a guess of $2.3m. But franchise rights are notoriously difficult to value, so this is just a guess. The similar right in a similar airport is still a different right in a different airport. But Greenie is a public limited company. So the $2.5m is the market value of the shares issued. No guesswork there.

Conclusion

The franchise valuer made a good guess, but really the outgoing equity and incoming franchise right are both worth $2.5m.

Alternative

Alternatively you could argue that the $2.3m is a reliable estimate of the franchise right. In which case both the outgoing equity and the incoming franchise right would be valued at $2.3m. The effect would be to ignore the $2.5m market value of the equity because of IFRS2s leaning towards using the incoming asset valuation.

Equity

The second part of (c) requires that we look at equity to assess the irredeemable preference shares. The meaning of equity is also less than perfect under current rules. In fact it is so bad the IASB have a project to come up with a useable definition of equity.

Current definition

Under current IAS32 equity is defined as the residual after you have used the assets to pay off the liabilities. This does not really tell you what equity is. In practice, accountants tend to use the idea that equity is not a liability where a liability has contractual obligations but equity does not. This is idea is less than perfect because even basic ordinary shares involve contractual rights. All very messy again.

Framework

The framework does not help much either. The framework just confirms that equity is the residual of assets less liabilities.

Greenie conclusion

Still that does not stop us from coming up with a suggestion. The obligation to pay a fixed annual dividend is very obviously a liability. So I suggest the liability component of the preference shares is estimated using discounted cash flow and the remainder of the balance is classified in equity.

Answer 57 Whitebirk

Lovely current issues question with the usual focus on narrative combined with some numbers.

(a)(i) Different approaches

The IASB had three different approaches available to the problem of dealing with the demand for reduced reporting for SMEs:-

(1) Ignore the demand

The IASB could have ignored the demand for international SME accounting and let local jurisdictions write their own SME rules locally.

Comment

This is exactly what the IASB did do at first. The result is that there are local SME rules in many jurisdictions (like the FRSSE in the UK).

(2) Appendix

The IASB could have put an appendix in the back of each IFRS saying how it applies to SMEs.

Comment

Fortunately the IASB rejected this idea because it would still mean that SMEs would have to buy the big book and get their heads around its cock eyed layout.

(3) Single IFRS

The IASB could have created a stand alone standard for SMEs; a one stop shop for smaller entity reporting.

Comment

Of course, this is exactly what the IASB did do. They claim it is 10% of the full IFRSs. But more significantly, it is much better set out and much clearer in its language.

(a)(ii) Main modifications

There are three forms of modification that the IFRS for SMEs used:

(1) Removal

The IASB removed inappropriate IFRS, such as EPS, interim reporting and segmental reporting.

(2) Alternatives

The full IFRS have lots of choice alternatives; like revaluation or cost for PPE. The IASB removed the more expensive choice. So the IFRS for SMEs allows only the cost model for PPE.

(3) Simplifications

Then the IASB looked at the worst of the IFRS complications and tried to make them simpler. So for example, to avoid the painful annual goodwill impairment review, the IFRS for SMEs substitutes annual depreciation. It even suggests a life of 10 years to really make it easy.

Definition of SME

The IASB decided to leave the decision as to the definition of an SME to legislators in each jurisdiction.

Recommendation

But the IASB recommends that the IFRS for SMEs should be made available to all entities without public interest. Public interest means finance companies (eg banks) or companies with shares or debt on a listed market (eg plcs).

(b)(i) Borrowing cost accounting

Full IFRS require the capitalisation of borrowing costs during building (IAS23). But the IFRS for SMEs prohibits this complexity.

Restatement

But the answer is complicated by the capitalisation occurring last year. So restatement of comparatives is required (prior period adjustment or PPA).

Solution

So the opening building carrying value of $540k must be restated to $450k before the current year depreciation of $50k is charged to leave a closing carrying value of $400k.

(b)(ii) Goodwill

The IFRS for SMEs requires the partial method and then depreciation.

Close

The goodwill would be:

	$m
FV of consideration	5.7
FV of na (90%)($6m)	(5.4)
Goodwill	0.3

Depreciation

This would then be one tenth of that; so $0.03m.

(b)(iii) R&D

The IFRS for SMEs rather brutally requires the write off of both research and development.

Comment

This certainly does not advantage the SME in terms of profit. It makes SME profit lower. But what it does do is allows the SME to avoid the tricky deferral test for development.

Solution

So the $500k would go into the income statement in full as incurred.

Question 58 Rose (Q1 June 2011)

Rose, a public limited company, operates in the mining sector. The draft statements of financial position are as follows, at 30 April 2011:

	Rose $m	Petal $m	Stem Dinars m
Assets:			
Non-current assets			
Property, plant and equipment	370	110	380
Investments in subsidiaries			
Petal	113		
Stem	46		
Financial assets	15	7	50
	544	117	430
Current assets	118	100	330
Total assets	662	217	760
Equity and liabilities:			
Share capital	158	38	200
Retained earnings	256	56	300
Other components of equity	7	4	–
Total equity	421	98	500
Non-current liabilities	56	42	160
Current liabilities	185	77	100
Total liabilities	241	119	260
Total equity and liabilities	662	217	760

The following information is relevant to the preparation of the group financial statements:

(i) On 1 May 2010, Rose acquired 70% of the equity interests of Petal, a public limited company. The purchase consideration comprised cash of $94 million. The fair value of the identifiable net assets recognised by Petal was $120 million excluding the patent below. The identifiable net assets of Petal at 1 May 2010 included a patent which had a fair value of $4 million. This had not been recognised in the financial statements of Petal. The patent had a remaining term of four years to run at that date and is not renewable. The retained earnings of Petal were $49 million and other components of equity were $3 million at the date of acquisition. The remaining excess of the fair value of the net assets is due to an increase in the value of land.

Rose wishes to use the 'full goodwill' method. The fair value of the non-controlling interest in Petal was $46 million on 1 May 2010. There have been no issues of ordinary shares since acquisition and goodwill on acquisition is not impaired.

Rose acquired a further 10% interest from the non-controlling interest in Petal on 30 April 2011 for a cash consideration of $19 million.

(ii) Rose acquired 52% of the ordinary shares of Stem on 1 May 2010 when Stem's retained earnings were 220 million dinars. The fair value of the identifiable net assets of Stem on 1 May 2010 was 495 million dinars. The excess of the fair value over the net assets of Stem is due to an increase in the value of land. The fair value of the non-controlling interest in Stem at 1 May 2010 was 250 million dinars.

Stem is located in a foreign country and operates a mine. The income of Stem is denominated and settled in dinars. The output of the mine is routinely traded in dinars and its price is determined initially by local supply and demand. Stem pays 40% of its costs and expenses in dollars with the remainder being incurred locally and settled in dinars. Stem's management has a considerable degree of authority and autonomy in carrying out the operations of Stem and is not dependent upon group companies for finance. Rose wishes to use the 'full goodwill' method to consolidate the financial statements of Stem. There have been no issues of ordinary shares and no impairment of goodwill since acquisition.

The following exchange rates are relevant to the preparation of the group financial statements:

	Dinars to $
1 May 2010	6
30 April 2011	5
Average for year to 30 April 2011	5·8

(iii) Rose has a property located in the same country as Stem. The property was acquired on 1 May 2010 and is carried at a cost of 30 million dinars. The property is depreciated over 20 years on the straight-line method. At 30 April 2011, the property was revalued to 35 million dinars. Depreciation has been charged for the year but the revaluation has not been taken into account in the preparation of the financial statements as at 30 April 2011.

(iv) Rose commenced a long-term bonus scheme for employees at 1 May 2010. Under the scheme employees receive a cumulative bonus on the completion of five years service. The bonus is 2% of the total of the annual salary of the employees. The total salary of employees for the year to 30 April 2011 was $40 million and a discount rate of 8% is assumed. Additionally at 30 April 2011, it is assumed that all employees will receive the bonus and that salaries will rise by 5% per year.

(v) Rose purchased plant for $20 million on 1 May 2007 with an estimated useful life of six years. Its estimated residual value at that date was $1·4 million. At 1 May 2010, the estimated residual value changed to $2·6 million. The change in the residual value has not been taken into account when preparing the financial statements as at 30 April 2011.

Required:

(a)(i) Discuss and apply the principles set out in IAS 21 The Effects of Changes in Foreign Exchange Rates in order to determine the functional currency of Stem.
(7 marks)

(a)(ii) Prepare a consolidated statement of financial position of the Rose Group at 30 April 2011, in accordance with International Financial Reporting Standards (IFRS. Ignore deferred taxation.
(35 marks)

(b) Rose was considering acquiring a service company. Rose stated that the acquisition may be made because of the value of the human capital and the opportunity for synergies and cross-selling opportunities. Rose estimated the fair value of the assets based on what it was prepared to pay for them. Rose further stated that what it was willing to pay was influenced by its future plans for the business.

The company to be acquired had contract-based customer relationships with well-known domestic and international companies and some mining companies. Rose estimated that the fair value of all of these customer relationships to be zero because Rose already enjoyed relationships with the majority of those customers.

Required:

Discuss the validity of the accounting treatment proposed by Rose and whether such a proposed treatment raises any ethical issues.

(6 marks)

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

(2 marks)
(50 marks)

Question 59 Lockfine (Q2 June 2011)

Lockfine, a public limited company, operates in the fishing industry and has recently made the transition to International Financial Reporting Standards (IFRS). Lockfine's reporting date is 30 April 2011.

(a) In the IFRS opening statement of financial position at 1 May 2009, Lockfine elected to measure its fishing fleet at fair value and use that fair value as deemed cost in accordance with IFRS 1 *First Time Adoption of International Financial Reporting Standards*. The fair value was an estimate based on valuations provided by two independent selling agents, both of whom provided a range of values within which the valuation might be considered acceptable. Lockfine calculated fair value at the average of the highest amounts in the two ranges provided. One of the agents' valuations was not supported by any description of the method adopted or the assumptions underlying the calculation. Valuations were principally based on discussions with various potential buyers. Lockfine wished to know the principles behind the use of deemed cost and whether agents' estimates were a reliable form of evidence on which to base the fair value calculation of tangible assets to be then adopted as deemed cost.

(6 marks)

(b) Lockfine was unsure as to whether it could elect to apply IFRS 3 *Business Combinations* retrospectively to past business combinations on a selective basis, because there was no purchase price allocation available for certain business combinations in its opening IFRS statement of financial position.

As a result of a major business combination, fishing rights of that combination were included as part of goodwill. The rights could not be recognised as a separately identifiable intangible asset at acquisition under the local GAAP because a reliable value was unobtainable for the rights. The fishing rights operated for a specified period of time.

On transition from local GAAP to IFRS, the fishing rights were included in goodwill and not separately identified because they did not meet the qualifying criteria set out in IFRS 1, even though it was known that the fishing rights had a finite life and would be fully

impaired or amortised over the period specified by the rights. Lockfine wished to amortise the fishing rights over their useful life and calculate any impairment of goodwill as two separate calculations.

(6 marks)

(c) Lockfine has internally developed intangible assets comprising the capitalised expenses of the acquisition and production of electronic map data which indicates the main fishing grounds in the world. The intangible assets generate revenue for the company in their use by the fishing fleet and are a material asset in the statement of financial position. Lockfine had constructed a database of the electronic maps. The costs incurred in bringing the information about a certain region of the world to a higher standard of performance are capitalised. The costs related to maintaining the information about a certain region at that same standard of performance are expensed. Lockfine's accounting policy states that intangible assets are valued at historical cost. The company considers the database to have an indefinite useful life which is reconsidered annually when it is tested for impairment. The reasons supporting the assessment of an indefinite useful life were not disclosed in the financial statements and neither did the company disclose how it satisfied the criteria for recognising an intangible asset arising from development.

(6 marks)

(d) The Lockfine board has agreed two restructuring projects during the year to 30 April 2011:

Plan A involves selling 50% of its off-shore fleet in one year's time. Additionally, the plan is to make 40% of its seamen redundant. Lockfine will carry out further analysis before deciding which of its fleets and related employees will be affected. In previous announcements to the public, Lockfine has suggested that it may restructure the off-shore fleet in the future.

Plan B involves the reorganisation of the headquarters in 18 months time, and includes the redundancy of 20% of the headquarters' workforce. The company has made announcements before the year end but there was a three month consultation period which ended just after the year end, whereby Lockfine was negotiating with employee representatives. Thus individual employees had not been notified by the year end.

Lockfine proposes recognising a provision in respect of Plan A but not Plan B.

(5 marks)

Professional marks will be awarded in question 2 for clarity and quality of discussion.

(2 marks)

Required:

Discuss the principles and practices to be used by Lockfine in accounting for the above valuation and recognition issues.

(25 marks)

Question 60 Alexandra (Q3 June 2011)

Alexandra, a public limited company, designs and manages business solutions and IT infrastructures.

(a) In November 2010, Alexandra defaulted on an interest payment on an issued bond loan of $100 million repayable in 2015. The loan agreement stipulates that such default leads to an obligation to repay the whole of the loan immediately, including accrued interest and expenses. The bondholders, however, issued a waiver postponing the interest payment until 31 May 2011. On 17 May 2011, Alexandra felt that a further waiver was required, so requested a meeting of the bondholders and agreed a further waiver of the interest payment to 5 July 2011, when Alexandra was confident it could make the payments. Alexandra classified the loan as long-term debt in its statement of financial position at 30 April 2011 on the basis that the loan was not in default at the end of the reporting period as the bondholders had issued waivers and had not sought redemption.

(6 marks)

(b) Alexandra enters into contracts with both customers and suppliers. The supplier solves system problems and provides new releases and updates for software. Alexandra provides maintenance services for its customers. In previous years, Alexandra recognised revenue and related costs on software maintenance contracts when the customer was invoiced, which was at the beginning of the contract period. Contracts typically run for two years.

During 2010, Alexandra had acquired Xavier Co, which recognised revenue, derived from a similar type of maintenance contract as Alexandra, on a straight-line basis over the term of the contract. Alexandra considered both its own and the policy of Xavier Co to comply with the requirements of IAS 18 *Revenue* but it decided to adopt the practice of Xavier Co for itself and the group. Alexandra concluded that the two recognition methods did not, in substance, represent two different accounting policies and did not, therefore, consider adoption of the new practice to be a change in policy.

In the year to 30 April 2011, Alexandra recognised revenue (and the related costs) on a straight-line basis over the contract term, treating this as a change in an accounting estimate. As a result, revenue and cost of sales were adjusted, reducing the year's profits by some $6 million.

(5 marks)

(c) Alexandra has a two-tier board structure consisting of a management and a supervisory board. Alexandra remunerates its board members as follows:

- Annual base salary
- Variable annual compensation (bonus)
- Share options

In the group financial statements, within the related parties note under IAS 24 *Related Party Disclosures*, Alexandra disclosed the total remuneration paid to directors and non-executive directors and a total for each of these boards. No further breakdown of the remuneration was provided.

The management board comprises both the executive and non-executive directors. The remuneration of the non-executive directors, however, was not included in the key management disclosures. Some members of the supervisory and management boards are of a particular nationality. Alexandra was of the opinion that in that jurisdiction, it is not acceptable to provide information about remuneration that could be traced back to individuals. Consequently, Alexandra explained that it had provided the related party

information in the annual accounts in an ambiguous way to prevent users of the financial statements from tracing remuneration information back to specific individuals.

(5 marks)

(d) Alexandra's pension plan was accounted for as a defined benefit plan in 2010. In the year ended 30 April 2011, Alexandra changed the accounting method used for the scheme and accounted for it as a defined contribution plan, restating the comparative 2010 financial information. The effect of the restatement was significant. In the 2011 financial statements, Alexandra explained that, during the year, the arrangements underlying the retirement benefit plan had been subject to detailed review. Since the pension liabilities are fully insured and indexation of future liabilities can be limited up to and including the funds available in a special trust account set up for the plan, which is not at the disposal of Alexandra, the plan qualifies as a defined contribution plan under IAS 19 *Employee Benefits* rather than a defined benefit plan. Furthermore, the trust account is built up by the insurance company from the surplus yield on investments. The pension plan is an average pay plan in respect of which the entity pays insurance premiums to a third party insurance company to fund the plan. Every year 1% of the pension fund is built up and employees pay a contribution of 4% of their salary, with the employer paying the balance of the contribution. If an employee leaves Alexandra and transfers the pension to another fund, Alexandra is liable for, or is refunded the difference between the benefits the employee is entitled to and the insurance premiums paid.

(7 marks)

Professional marks will be awarded in question 3 for clarity and quality of discussion.

(2 marks)

Required:

Discuss how the above transactions should be dealt with in the financial statements of Alexandra for the year ended 30 April 2011.

(25 marks)

Question 61 Grainger (June 2011)

The publication of IFRS 9, *Financial Instruments*, represents the completion of the first stage of a three-part project to replace IAS 39 *Financial Instruments: Recognition and Measurement* with a new standard. The new standard purports to enhance the ability of investors and other users of financial information to understand the accounting of financial assets and reduces complexity.

Required:

(a)(i)Discuss the approach taken by IFRS 9 in measuring and classifying financial assets and the main effect that IFRS 9 will have on accounting for financial assets.

(11 arks)

(a)(ii) Grainger, a public limited company, has decided to adopt IFRS 9 prior to January 2012 and has decided to restate comparative information under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The entity has an investment in a financial asset which was carried at amortised cost under IAS 39 but will be valued at fair value through profit and loss (FVTPL) under IFRS 9. The carrying value of the assets was $105,000 on 30 April 2010 and $110,400 on 30 April 2011. The fair value of the asset was $106,500 on 30 April 2010 and $111,000 on 30 April 2011. Grainger has determined that the asset will be valued at FVTPL at 30 April 2011.

Required:

Discuss how the financial asset will be accounted for in the financial statements of Grainger in the year ended 30 April 2011.

(4 marks)

(b) Recently, criticisms have been made against the current IFRS impairment model for financial assets (the incurred loss model). The issue with the incurred loss model is that impairment losses (and resulting write-downs in the reported value of financial assets) can only be recognised when there is evidence that they exist and have been incurred. Reporting entities are not allowed currently to consider the effects of expected losses. There is a view that earlier recognition of loan losses could potentially reduce the problems incurred in a credit crisis.

Grainger has a portfolio of loans of $5 million which was initially recognised on 1 May 2010. The loans mature in 10 years and carry an interest rate of 16%. Grainger estimates that no loans will default in the first two years, but from the third year onwards, loans will default at an annual rate of about 9%. If the loans default as expected, the rate of return from the portfolio will be approximately 9·07%. The number of loans are fixed without any new lending or any other impairment provisions.

Required:

(i) **Discuss briefly the issues related to considering the effects of expected losses in dealing with impairment of financial assets.**

(4 marks)

(ii) **Calculate the impact on the financial statements up to the year ended 30 April 2013 if Grainger anticipated the expected losses on the loan portfolio in year three.**

(4 marks)

Professional marks will be awarded in question 4 for clarity and quality of discussion.

(2 marks)

(25 marks)

Answer 58 Rose

(a)(i)

1 mark per point.

You may notice that this requirement is a direct lift from the question Ribby from June 2008.

Functional currency

The functional currency of an entity is simply the currency in which the entity functions. The functional currency is the currency of the primary economic environment. So the functional currency is determined by what an entity does and which currencies the entity uses.

Presentational currency

The presentational currency of an entity is the currency in which an entity presents its financial statements. The presentational currency is determined by shareholder demand.

Foreign subs

Of course, most entities function and present in the same currency. But foreign subs are usually required to present to the parent in the parent currency and this gives rise to a separation of the two currencies.

Mixed currencies

However, even foreign subs rarely have a problem figuring out their functional currency. But some foreign subs use a mix of two or more currencies and these subs have more of a problem. They have to pick one of their currencies as the functional currency even through in reality they function in two or more.

Guidance

IAS21 guidance in this area is fairly simple. An entity that functions in more than one currency should weigh up the various currencies and functions and pick the dominant currency as the functional currency.

Competitive behaviour

IAS21 gives further guidance that the functional currency is the currency that influences sales prices. It is the currency of the competitive forces.

Application

The application to Stem is fairly easy. Paragraph 2 tells us that most of the functions cash flows are in dinar. Further, that paragraph tells us that the output of the mine is traded in dinar at a price determined by local supply and demand.

Conclusion

The functional currency of Stem is the dinar. So stem will do all its bookkeeping in dinar and produce initial fs in that currency, as it has done already. Then Stem will translate those fs to dollars for the parent.

(a) (ii) **Net assets**

	Petal		Stem	
	Acq	*Y/e*	*Acq*	*Y/e*
SC	38	38	200	200
RE	49	56	220	300
OCE	3	4	-	-
FVA (intangible)	4	3	-	-
FVA (land) β	30	30	75	75
(120 + 4)	124	131	495	575
Growth	7		80	

Note: Intangible FVA has depreciation of $1m and land FVA is a balancing figure.

Goodwill

	%	*Working*	*Petal*	%	*Working*	*Stem*
FV of consideration	70		94	52	($46m)(6)	276
FV of NCI	30		46	48		250
FV of NA			(124)			(495)
Goodwill			16			31

Transfer (1)

NCI before [46 + (30%)(7)]	48.1
Transfer (10%/30%)(48.1)	(16.0)
NCI after	32.1

Effect

Transfer in	16.0
Consideration out	(19.0)
Reduction in OCE	(3.0)

Group position statement

Non-current assets	
Goodwill (16 + 31/5)	22
Property plant and equipment [370 + 110 + 30 + (380 + 75)/5 + 2.25 (para 3) + 0.4 (para 5)]	604
Intangible (para (1) FVA)	3
Financial assets (15 + 7 + 50/5)	32
Current assets (118 + 100 + 330/5)	284
	945
Equity	
Share capital	158
Retained earnings	278
Other components of equity [7 – 3 (para 1) + 2.25 (para 3)]	6
Non-controlling interest [32.1 (transfer) + 57.7 (below)]	90
Non-current liabilities [56 + 42 + 160/5 + 0.6 (para 4)]	131
Current liabilities (185 + 77 + 100/5)	282
	945

NCI (Stem)

[250 + 80 (48%)]/5 = 57.7

Working 3

Cost D30m/6	5.00
Depreciation $5m/20 yrs	(0.25)
Closing before	4.75
Revaluation (to OCE)	2.25
Closing after (given)	7.00

Working 4

	$m
Current salary	40.0
Percentage	2%
Current bonus	0.8
Discount factor (1/1.08 power 4)	0.735
Approximate value of current bonus	0.6

Working 5

	Actual $m		*Correct* $m
Cost	20.0		20.0
Depreciation (20.0 – 1.4)/6 yrs	(3.1)		(3.1)
Depreciation	(3.1)		(3.1)
Depreciation	(3.1)		(3.1)
Opening	10.7		10.7
Depreciation (20.0 – 1.4)/6 yrs	(3.1)	(10.7 – 2.6)/3 yrs	(2.7)
Closing	7.6		8.0

Retained earnings

Parent	256.0
Para (3)	-
Para (4)	(0.6)
Para (5)	0.4
Petal (70%)(7)	4.9
Stem (52%)(80)/5	8.3
Forex (below)	9.2
	278.2

Forex

276/5	55.2
276/6	(46.0)
Gain	9.2

Split growth

Strictly you should split the growth in Petal as follows:

To RE	6
To OCE (4 – 3)	1
Growth (from NA)	7

So strictly the retained earnings should be $0.7m less (70% of $1m) and OCE should be $0.7m more. But you would be mad to do this is in an exam.

(b)

1 mark per point

Goodwill

Fair value in acquisition accounting is required especially in the recognition and measurement of goodwill:-

FV of consideration	x
FV of nci	x
FV of net assets	(x)
Goodwill	xx

Fair value

Fair value is the transaction price between market players (IFRS13). When there is no market, fair value is an estimated arm's length transaction price between willing parties.

Rose

Rose appears to have misunderstood this idea. Rose wants to interpret fair value as the value that Rose itself attaches to the various assets and in particular the customer relationships.

Customer relationships

But the customer relationships should be separated from the goodwill (IFRS3) and valued at market value (IFRS13).

Measurement

To estimate fair value, Rose should attempt to estimate the price that other competitors would pay for those customer relationships. It is likely that other competitors do not have these relationships and therefore would be prepared to pay a substantial sum for these relationships.

Ethics

It is possible that Rose knows and understands all this, but simply wants to close its eyes to the value of the customer relationships in order to avoid recognition and subsequent deprecation and impairment.

Conclusion

However, my feeling is that this is complex accounting. Fair value and acquisition net assets are often misunderstood. Besides, if net assets are undervalued then a compensating balance for goodwill simply comes on to the b/s. If Rose understates the customer relationship value, then Rose simply overstates goodwill. So I think this may be a simple mistake.

Answer 59 Lockfine

This was a focus question based upon focus on IFRS1. However, because IFRS1 is first time adoption and applies right across the financial statements and all the areas of accounting the question was effectively a mix question. Because Lockfine was placed in the fishing industry this is also an industry question. So there is little practical difference between Lockfine (q2) and Alexandra (q3).

The usual 1 mark per point applies throughout.

(a)

Property plant and equipment

The IAS on PPE (IAS16) allows companies to choose between two different models; either the cost model or the fair value model, sometimes called revaluation.

First time adoption

However, perhaps a little oddly, IFRS1 allows entities adopting IFRS for the first time to use fair value as cost at the beginning of their comparative period. The question tells us this.

Lockfine

Lockfine has selected cost model. Also Lockfine has chosen to use comparative opening fair value as initial cost. This is all fine.

Fair value

Fair value should represent a transaction price between market participants at the measurement date (IFRS1).

Market value

There is no capital market for fishing boats like there is for Microsoft shares. Fishing boats are all different and you do not see the line "Fishing Boats" on the London Stock Exchange. So capital market value is unavailable (level 1 input).

Selling agent valuations

But the selling agents' valuations are a good substitute for the above (good level 2 inputs). It should be especially noted that the selling agents' valuations are based on conversations with players in the fishing industry who might want to buy boats.

Criticism

Perhaps my only criticism in the use of the average of the highest two figures. I think I would recommend the average of the middle two figures.

Conclusion

Lockfine accounting for ppe on first time adoption is largely acceptable.

(b)

First time adoption

IFRS1 takes the view that ideally companies should go back to last year's opening figures and make those figures perfect. Ideally IFRS1 would like to see opening comparatives that look as if the company had always used IFRS.

Practicality

But fortunately IFRS1 is also practical. IFRS1 understands that it might be a nightmare to go back to transactions that are long dead to work out what would have been recorded under IFRS just to get your opening figures dead right. So IFRS1 has a number of areas where retrospective accounting is not required or even expected.

Goodwill

One of these areas is goodwill and the recalculation of old acquisition consideration and old acquisition net assets. IFRS1 will accept the old goodwill under the local GAAP as the opening goodwill under IFRS.

Consistency

But on the other hand, if you can go back to old sub acquisitions and recalculate goodwill, then IFRS1 would certainly accept this. But retrospective application must of course be consistent.

Lockfine

It sounds like Lockfine finds itself in the relatively common position of being able to remeasure some of the old goodwill, but not all. So Lockfine should just use the local GAAP goodwill as IFRS goodwill.

Intangible

It also sounds like Lockfine has an intangible tangled up in its goodwill and that Lockfine wants to pull this out and stick it on a separate line.

Conclusion

Lockfine cannot do this as this untangling of an intangible remeasures one goodwill and not others. This inconsistency is not allowed as mentioned above. But quite separately Lockfine cannot do this because Lockfine cannot measure the intangible because a reliable value was unobtainable.

(c)

Intangible assets (IAS38)

The IAS on intangible assets is less than perfect because it can often lead to quite different results depending on interpretation. The basic recognition criteria are simple enough; an intangible must have future economic benefits and must be measured reliably. But it in the interpretation of those two that the problems arise.

Purchased

IAS38 requires that for an intangible to be measured reliably the intangible must be purchased (either individually or as part of a sub acquisition).

Lockfine

Clearly that does not apply to the electronic map data. So it appears that this is game over and the costs must be written off.

Development

However, if Lockfine tries to claim that the costs are development costs then Lockfine may be able to make a case. The criteria are:-

D defined project

E expenditure identifiable

F feasible

E expected profit

R resources adequate

Analysis

The data project does appear to fulfil all the criteria, even the one about expected profit. The profit will come from reducing Lockfine costs. So Lockfine may defer this intangible cost as development.

Conclusion

I think it is possible to recognise an intangible, although I can see that others might take a different view.

Life

IAS38 does allow that some intangibles might have an infinite life when there is no foreseeable limit to the cash flows. But this just does not seem to apply to fish. Surely fish move around and sea water gets hotter and colder and sharks and whales and diseases come and go.

Finite

I know very little about fish but my suggestion is that the data has a finite life and should be depreciated.

(d)

Provisions

The IFRS on provisions requires the recognition of a provision if the following criteria are met:-

R reasonably reliable estimate

O obligation

T transfer

Estimate and Transfer

I think both of these two criteria are fulfilled by both plans. An estimate is possible in both cases and of course there will be an outflow of benefits transferring out of Lockfine when the plans are executed.

Obligation

There is no legal obligation in either case. So that brings us to the slippery subject of the constructive obligation. A constructive obligation exists when a statement creates an expectation, but that can sometimes be very hard to nail down.

Plan a

Lockfine has made an announcement but all Lockfine has announced is that it is thinking of selling half the fleet and that further analysis is required.

Conclusion plan a

I think on balance that plan a is too wobbly to have created an expectation (although it will have created fear!). So I think that Lockfine should not provide for plan a.

Plan b

Plan b is similar, but to me it sounds like plan b is further down the line. Lockfine has even started negotiating with the employee representatives.

Conclusion plan b

It sounds to me like plan b is a definite plan and as such the statement of restructuring will have created the expectation of redundancy. So I think Lockfine should provide.

Restructuring

Because the IASB knew that restructuring constructive obligations are slippery, IAS38 actually contains detailed advice on restructuring constructive obligations. The advice requires that the plan be formal and detailed and those effected must be expecting to be paid off. I think this simply reinforces the earlier conclusions.

Answer 60 Alexandra

This was a classic industry question requiring the application of a mix of standards.

The marking guide throughout was a simple "1 mark per point". So as usual, very different answers to this question could score full marks.

(a)

Current liabilities (cl)

Current liabilities are simply liabilities falling due for payment within 12 months from the year end.

Statement of financial position

A statement of financial position is intended to be a statement of financial position at the year end and not the position earlier in the year or the position later in the future.

Irrelevant

So it is irrelevant when the loan was originally due. Also it is irrelevant when the loan might be paid after the year end.

Interest

The position as regards the interest is crystal clear. The waiver extends the interest due date to 17 May. This is well within 12 months. So the interest is cl.

Principal

The position as regards the principal of $100m is not clear. The waiver seems to say nothing about the principal. So perhaps the principal is still due immediately.

Alternatively

But perhaps the waiver extends to the principle also and that is currently waived until 17 May.

Conclusion

In either case the principal is also due within 12 months. So the principal is cl at the current year end.

(b)

Revenue

Revenue has two models under IAS18:-

"At" = revenue at a point in time is recognised at the point in time that risks and rewards transfer (goods)

"Over" = revenue over a period is recognised over that period and so only to the extent of completion in any one period (services)

Interpretive

It is true that IAS18 is highly interpretative and requires intuition and so it is possible for two people to look at one revenue stream and get different answers.

Maintenance service

However, I would suggest that maintenance service is so obviously a service with revenue to be recognised over a period that I really think that Alexandra was simply wrong to recognise revenue at the point of signature.

Sub acquisition

The sub acquisition has made Alexandra realise the mistake. Now Alexandra is using the straight-line method implied by the revenue stream for the current year which is good.

Error

However, Alexandra has not acknowledged that the earlier policy was wrong. Last year's fs had a fundamental error.

Prior period adjustment (PPA)

Alexandra must restate the comparatives and the effect of the PPA will be to throw some of last year's revenue forward to this year.

(c)

Related Parties

IAS24 is a very messy standard with bags of detail, but the principal of the related party is simple enough. A party is related to an entity if there exists a relationship of control or influence.

Directors

All the directors on both boards are in a position of influence at very least. So all directors are related parties.

Disclosure

IAS24 requires related party transactions (rpt) to be disclosed in full. That means all the obvious stuff:-

Parties

Relationship

Transactions

And so on.

Effect

The effect is that all directors must be named and all their various forms of remuneration must be explained in full, including the option schemes.

Corporate social responsibility (CSR)

Quite apart from the requirement to disclose under IAS24, Alexandra has a requirement to disclose under CSR. This later responsibility is almost certainly given in the corporate governance of the stock exchange upon which Alexandra is quoted.

(d)

Pension schemes

There are two forms of pension given in IAS19 and they are distinguished primarily based upon the element of the scheme that is defined. This means you can tell which scheme you have depending on the risks and rewards of stock exchange (SE) movements.

Defined contribution

A defined contribution scheme defines the contributions that the company must pay the employee. This kind of contract makes no promises regarding the eventual value of the benefit.

SE movement

Thus the employee will choose where to put his pension money. So ups and downs in pension value result from his choices. Therefore if the SE goes down then the employee will suffer but the company will be unaffected.

Defined benefit

But if the company defines the benefit that will be given to the employee when he retires, then the company does make promises regarding the value of the eventual benefit.

SE movement

So the company will choose where to put the money in the hope that there will be enough at the end to pay the employee off. Therefore if the SE goes down then the company must top up the difference.

Alexandra Review

The results of the review are very complex and hard to read. But the last sentence gives away the situation: "Alexandra is liable for the difference". So Alexandra still has the risk of a SE fall.

Conclusion

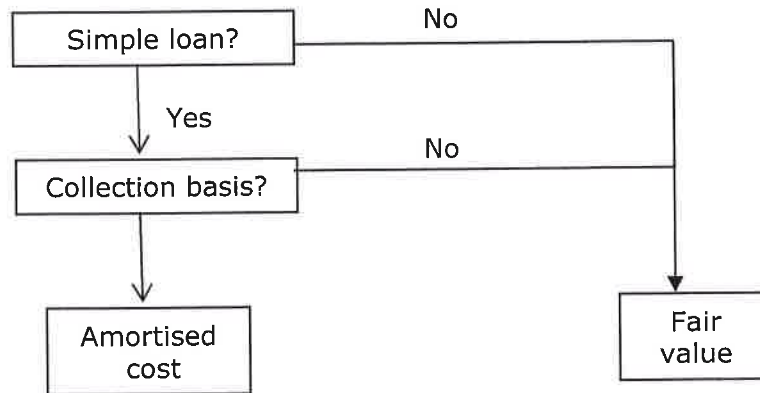
You can see from the above that Alexandra still has a defined benefit pension scheme. So Alexandra must continue to recognise an asset and liability, as before.

Answer 61 Grainger

(a)(i)

IFRS9

IFRS9 uses two questions to classify financial assets (FAs):



Question (1) Simple loan?

IFRS9 is effectively asking 'Is the FA a loan and does the loan have interest and principal repayment with no other terms?'

Cash flow characteristics test

The technical name for this question is the cash flow characteristics test.

Question (2) Collection basis?

IFRS9 is effectively asking 'Are you holding the FA in order to collect that interest and principal repayment?'

Intent

So IFRS9 is looking at the intent to keep (collection basis) or the intent to sell (speculation basis).

Business model test

The technical name for this test is the business model test.

Yes/No

IFRS9 requires two 'yes' for amortised cost but only requires one 'no' for fair value.

Amortised cost

Carrying an asset at amortised cost means initial recognition at initial fair value and then unwinding.

Fair value

Carrying a FA at fair value means marking the asset to market at each measurement point.

Default

The gains and losses then default into the income statement (IS).

FVTPL

This recognition method is often referred to as FVTPL (Financial asset at fair through profit and loss: see iasplus.com for example).

Extended model

So in summary, IFRS9 allows two simple recognition and measurement methods (amortised cost and fair value) based on two simple tests. However, the basic model is extended by two options discussed below. They are the FATOCI option and the Fair Value Option.

Strategic equity

If you hold an equity investment and can show long-term strategic intent, then the gains and losses can go to the OCI.

FVTOCI

So often this this strategic equity is called FVTOCI (Financial asset at fair through other comprehensive income).

FVO

Finally there is the fair value option. This gives directors the option to carry FA that should be carried at amortised cost at fair value instead.

Mismatch

However this is only permitted if there is an accounting mismatch. An accounting mismatch occurs if there is a FL at fair value and a related FA at amortised cost.

Main effect

The main effect is that accounting under IFRS9 will be much easier than under IAS39.

(a)(ii)
FVTPL
Fair value through profit or loss is literal. FVTPL assets are carried at fv on the b/s and gains and losses go through the p/l.

Effect
Therefore, the asset will be carried at its fair value of $111k at the year end on the position statement. The gain of $4.5k (111-106.5) will be reported in profit or loss.

Change of accounting policy
The change in the classification of the asset has arisen due to the adoption of the new standard. The change in classification has nothing to do with the asset itself. So this is a change in accounting policy.

Restatement
So the comparative (opening) b/s will need to pick up the opening fv of $106.5k.

Prior period adjustment
This will necessitate a PPA of $1.5k (106.5-105) to be disclosed in the notes.

Further disclosure
The reason for the PPA (the new standard) must also be disclosed along with the PPA itself.

(b)(i)
Current model
The current model for impairment is called the incurred loss model as only losses that have been incurred can be recognised. This effect derives from the recognition criteria. There must be objective evidence before an impairment is recognised and that only happens once a loss in incurred.

Politics
But impairment is a particularly political subject. This is because it is highly relevant to banking and, as we have seen from recent years, banking is a highly politicised industry. The trouble with only recognising impairment losses when they happen is that they tend to happen all at once and if the banks recognise the impairment losses all at once then this may make a recession worse.

Proposed model
So the proposal is to develop an expected loss model. This will allow banks in particular to recognise predictable losses in a portfolio of assets before those losses occur.

Problem
That sounds easy enough. But how do you predict losses? Clearly the banks are less than brilliant at predicting losses themselves. They invested heavily in sub-prime debt assets apparently blissfully unaware they were toxic.

(b)(ii)

Incurred loss model

Here is the basic incurred loss model first, applied to the Grainger figures:-

Date	Loan asset (A)	Interest (B)[at 16%]	Cash flow	Loss (C)	Loan asset	Return (B – C)/A%
$000	$000	$000	$000	$000		
y/e 30 April 11	5,000	800	(800)	0	5,000	16%
y/e 30 April 12	5,000	800	(800)	0	5,000	16%
y/e 30 April 13	5,000	800	(728)	522	4,550	5•56%
			[728= 800 x 91%]			

Expected loss model

Here is the proposed model applied to Grainger:-

Date	Loan asset (A)	Interest (B) [at 9•07%]	Cash flow	Loan asset	Return B/A%
	$000	$000	$000	$000	
y/e 30 April 11	5,000	453•5	(800)	4,653•5	9•07%
y/e 30 April 12	4,653•5	422•1	(800)	4,275•6	9•07%
y/e 30 April 13	4,275•6	387•8	(728)	3,935•4	9•07%

Question 62 Traveler (Q1 December 2011)

Traveler, a public limited company, operates in the manufacturing sector. The draft statements of financial position are as follows at 30 November 2011:

	Traveler	Data	Captive
	$m	$m	$m
Assets:			
Non-current assets			
Property, plant and equipment	439	810	620
Investments in subsidiaries			
Data	820		
Captive	541		
Financial assets	108	10	20
	1,908	820	640
Defined benefit asset	72		
Current assets	995	781	350
Total assets	2,975	1,601	990
Equity and liabilities:			
Share capital	1,120	600	390
Retained earnings	1,066	442	169
Other components of equity	60	37	45
Total equity	2,246	1,079	604
Non-current liabilities	455	323	73
Current liabilities	274	199	313
Total liabilities	729	522	386
Total equity and liabilities	2,975	1,601	990

The following information is relevant to the preparation of the group financial statements:

1 On 1 December 2010, Traveler acquired 60% of the equity interests of Data, a public limited company. The purchase consideration comprised cash of $600 million. At acquisition, the fair value of the non-controlling interest in Data was $395 million. Traveler wishes to use the 'full goodwill' method. On 1 December 2010, the fair value of the identifiable net assets acquired was $935 million and retained earnings of Data were $299 million and other components of equity were $26 million. The excess in fair value is due to non-depreciable land. On 30 November 2011, Traveler acquired a further 20% interest in Data for a cash consideration of $220 million.

2 On 1 December 2010, Traveler acquired 80% of the equity interests of Captive for a consideration of $541 million. The consideration comprised cash of $477 million and the transfer of non-depreciable land with a fair value of $64 million. The carrying amount of the land at the acquisition date was $56 million. At the year end, this asset was still included in the non-current assets of Traveler and the sale proceeds had been credited to profit or loss. At the date of acquisition, the identifiable net assets of Captive had a fair value of $526 million, retained earnings were $90 million and other components of equity were $24 million. The excess in fair value is due to non-depreciable land. This acquisition was accounted for using the partial goodwill method in accordance with IFRS 3 (Revised) Business Combinations.

3 Goodwill was impairment tested after the additional acquisition in Data on 30 November 2011. The recoverable amount of Data was $1,099 million and that of Captive was $700 million.

4 Included in the financial assets of Traveler is a ten-year 7% loan. At 30 November 2011, the borrower was in financial difficulties and its credit rating had been downgraded. Traveler has adopted IFRS 9 Financial Instruments and the loan asset is currently held at amortised cost of $29 million. Traveler now wishes to value the loan at fair value using current market interest rates. Traveler has agreed for the loan to be restructured; there will only be three more annual payments of $8 million starting in one year's time. Current market interest rates are 8%, the original effective interest rate is 6·7% and the effective interest rate under the revised payment schedule is 6·3%.

5 Traveler acquired a new factory on 1 December 2010. The cost of the factory was $50 million and it has a residual value of $2 million. The factory has a flat roof, which needs replacing every five years. The cost of the roof was $5 million. The useful economic life of the factory is 25 years. No depreciation has been charged for the year. Traveler wishes to account for the factory and roof as a single asset and depreciate the whole factory over its economic life. Traveler uses straight-line depreciation.

6 The actuarial value of Traveler's pension plan showed a surplus at 1 December 2010 of $72 million, represented by the fair value of the assets of $250 million, the present value of the defined benefit obligation of $200 million and net unrecognised actuarial losses of $22 million. The average remaining working lives of the employees is 10 years. Traveler uses the corridor approach for recognising actuarial gains and losses. The aggregate of the current service cost, interest cost and expected return on assets amounted to a cost of $55 million for the year. After consulting with the actuaries, the company decided to reduce its contributions for the year to $45 million. The contributions were paid on 7 December 2011. No entries had been made in the financial statements for the above amounts. At the year end, the unrecognised actuarial losses were $20 million and the present value of available future refunds and reductions in future contributions was $18 million.

Required:

(a) Prepare a consolidated statement of financial position for the Traveler Group for the year ended 30 November 2011.

(35 marks)

(b) Traveler has three distinct business segments. The management has calculated the net assets, turnover and profit before common costs, which are to be allocated to these segments. However, they are unsure as to how they should allocate certain common costs and whether they can exercise judgement in the allocation process. They wish to allocate head office management expenses; pension expense; the cost of managing properties and interest and related interest bearing assets. They also are uncertain as to whether the allocation of costs has to be in conformity with the accounting policies used in the financial statements.

Required:

Advise the management of Traveler on the points raised in the above paragraph.

(7 marks)

(c) Segmental information reported externally is more useful if it conforms to information used by management in making decisions. The information can differ from that reported in the financial statements. Although reconciliations are required, these can be complex and difficult to understand. Additionally, there are other standards where subjectivity is involved and often the profit motive determines which accounting practice to follow. The directors have a responsibility to shareholders in disclosing information to enhance corporate value but this may conflict with their corporate social responsibility.

Required:

Discuss how the ethics of corporate social responsibility disclosure are difficult to reconcile with shareholder expectations.

(6 marks)

Professional marks will be awarded in part (c) for clarity and expression of your discussion.

(2 marks)

(50 marks)

Question 63 Decany (Q2 December 2011)

Decany owns 100% of the ordinary share capital of Ceed and Rant. All three entities are public limited companies. The group operates in the shipbuilding industry, which is currently a depressed market. Rant has made losses for the last three years and its liquidity is poor. The view of the directors is that Rant needs some cash investment. The directors have decided to put forward a restructuring plan as at 30 November 2011. Under this plan:

1. Ceed is to purchase the whole of Decany's investment in Rant. The purchase consideration is to be $98 million payable in cash to Decany and this amount will then be loaned on a long-term unsecured basis to Rant; and

2. Ceed will purchase land with a carrying amount of $10 million from Rant for a total purchase consideration of $15 million. The land has a mortgage outstanding on it of $4 million. The total purchase consideration of $15 million comprises both five million $1 nominal value non-voting shares issued by Ceed to Rant and the $4 million mortgage liability which Ceed will assume; and

3. A dividend of $25 million will be paid from Ceed to Decany to reduce the accumulated reserves of Ceed.

The Statements of Financial Position of Decany and its subsidiaries at 30 November 2011 are summarised below:

	Decany	Ceed	Rant
	$m	$m	$m
Non-current assets			
Tangible non-current assets	600	170	45
Cost of investment in Ceed	130		
Cost of investment in Rant	95		
Current assets	155	130	20
	980	300	65
Equity and reserves			
Share capital	140	70	35
Retained earnings	750	220	5
	890	290	40
Non-current liabilities			
Long-term loan	5		12
Current liabilities			
Trade payables	85	10	13
	980	300	65

As a result of the restructuring, several of Ceed's employees will be made redundant. According to the detailed plan, the costs of redundancy will be spread over two years with $4 million being payable in one year's time and $6 million in two years' time. The market yield of high quality corporate bonds is 3%. The directors feel that the overall restructure will cost $2 million.

Required:

(a) (i) Prepare the individual entity statements of financial position after the proposed restructuring plan;

(13 marks)

(ii) Set out the requirements of IAS 27 Consolidated and Separate Financial Statements as regards the reorganisation and payment of dividends between group companies, discussing any implications for the restructuring plan.

(5 marks)

(b) Discuss the key implications of the proposed plans for the restructuring of the group.

(5 marks)

Professional marks will be awarded in part (b) for clarity and expression of your discussion.

(2 marks)

(25 marks)

Question 64 Scramble (Q3 December 2011)

Scramble, a public limited company, is a developer of online computer games.

(a) At 30 November 2011, 65% of Scramble's total assets were mainly represented by internally developed intangible assets comprising the capitalised costs of the development and production of online computer games. These games generate all of Scramble's revenue. The costs incurred in relation to maintaining the games at the same standard of performance are expensed to the statement of comprehensive income. The accounting policy note states that intangible assets are valued at historical cost. Scramble considers the games to have an indefinite useful life, which is reconsidered annually when the intangible assets are tested for impairment. Scramble determines value in use using the estimated future cash flows which include maintenance expenses, capital expenses incurred in developing different versions of the games and the expected increase in turnover resulting from the above mentioned cash outflows. Scramble does not conduct an analysis or investigation of differences
between expected and actual cash flows. Tax effects were also taken into account.

(7 marks)

(b) Scramble has two cash generating units (CGU) which hold 90% of the internally developed intangible assets. Scramble reported a consolidated net loss for the period and an impairment charge in respect of the two CGUs representing 63% of the consolidated profit before tax and 29% of the total costs in the period. The recoverable amount of the CGUs is defined, in this case, as value in use. Specific discount rates are not directly available from the market, and Scramble estimates the discount rates, using its weighted average cost of capital. In calculating the cost of debt as an input to the determination of the discount rate, Scramble used the risk-free rate adjusted by the company specific average credit spread of its outstanding debt, which had been raised two years previously. As Scramble did not have any need for additional financing and did not need to repay any of the existing loans before 2014, Scramble did not see any reason for using a different discount rate. Scramble did not disclose either the events or circumstances that led to the recognition of the impairment loss or the amount of the loss recognised in respect of each cash-generating unit. Scramble felt that the events and circumstances that led to the recognition of a loss in respect of the first CGU were common knowledge in the market and the events and the circumstances that led to the recognition loss of the second CGU were not needed to be disclosed.

(7 marks)

(c) Scramble wished to diversify its operations and purchased a professional football club, Rashing. In Rashing's financial statements for the year ended 30 November 2011, it was proposed to include significant intangible assets which related to acquired players' registration rights comprising registration and agents' fees. The agents' fees were paid by the club to players' agents either when a player is transferred to the club or when the contract of a player is extended. Scramble believes that the registration rights of the players are intangible assets but that the agent's fees do not meet the criteria to be recognised as intangible assets as they are not directly attributable to the costs of players' contracts. Additionally, Rashing has purchased the rights to 25% of the revenue from ticket sales generated by another football club, Santash, in a different league. Rashing does not sell these tickets nor has any discretion over the pricing of the tickets. Rashing wishes to show these rights as intangible assets in its financial statements.

(9 marks)

Required:

Discuss the validity of the accounting treatments proposed by Scramble in its financial statements for the year ended 30 November 2011.

The mark allocation is shown against each of the three accounting treatments above.

Professional marks will be awarded for clarity and expression of your discussion.

(2 marks)

(25 marks)

Question 65 Venue (Q4 December 2011)

It is argued that there is limited revenue recognition guidance available from IFRS with many companies following the current provisions of US GAAP. The revenue recognition standard, IAS 18 Revenue, has been criticised because an entity applying the standards might recognise amounts in the financial statements that do not faithfully represent the nature of the transactions. It has been further argued that current standards are inconsistent with principles used in other accounting standards, and further that the notion of the risks and rewards of ownership has also been subjectively applied in sale transactions.

Required:

(a) (i) Discuss the main weaknesses in the current standard on revenue recognition;
(11 marks)

(a) (ii) Discuss the reasons why it might be relevant to take into account credit risk and the time value of money in assessing revenue recognition.
(5 marks)

Professional marks will be awarded in part (a) for clarity and expression of your discussion.
(2 marks)

(b) (i) Venue enters into a contract with a customer to provide computers at a value of $1 million. The terms are that payment is due one month after the sale of the goods. On the basis of experience with other contractors with similar characteristics, Venue considers that there is a 5% risk that the customer will not pay the amount due after the goods have been delivered and the property transferred. Venue subsequently felt that the financial condition of the customer has deteriorated and that the trade receivable is further impaired by $100,000.

(b) (ii) Venue has also sold a computer hardware system to a customer and, because of the current difficulties in the market, Venue has agreed to defer receipt of the selling price of $2 million until two years after the hardware has been transferred to the customer. Venue has also been offering discounts to customers if products were sold with terms whereby payment was due now but the transfer of the product was made in one year. A sale had been made under these terms and payment of $3 million had been received. A discount rate of 4% should be used in any calculations.

Required:
Discuss how both of the above transactions would be treated in subsequent financial statements under IAS 18 and also whether there would be difference in treatment if the collectability of the debt and the time value of money were taken into account.
(7 marks)
(25 marks)

Answer 62 Traveler

(a)(i) **Net assets**

	Data Acq	*Data Y/e*	*Captive Acq*	*Captive Y/e*
SC	600	600	390	390
RE	299	442	90	169
OCE	26	37	24	45
FVA (land) β{balance}	10	10	22	22
	935	1089	526	626
Growth	154		100	

(2 marks: 1 mark for each FVA)

	Data	Captive
OCE growth (37-26)&(45-24)	11	21
RE growth β{balance}	143	79
Growth	154	100

Note: If split growth above is beyond you, then treat the whole growth as RE growth and you will lose only a mark in the reserves working.

Goodwill

	%	*Working*	*Data*	*%*	*Working*	*Captive*
FV of consideration	60%		600	80%		541
FV of NCI	40%		395	20%	(20%)(526)	105
FV of NA			(935)			(526)
Goodwill before			60			120
Impairment			(50)			(61)
Goodwill after			10			59

(4 marks: 2 marks for each goodwill before impairment)

Impairment

		Data		Captive
Carrying value	[60+1089]	1149	[120+(80%(626)]	621
Impairment β{balance}		(50)		61
Recoverable value		1099	[80%(700)]	560
CI element	80%	40		61
NCI element	20%	10		
Impairment (above)		50		61

(4 marks: 2 marks for each impairment including the split)

Note: Full goodwill is the goodwill of the entire entity. So to work full goodwill impairment we use the carrying value and recoverable value of the entire entity. However, partial goodwill is only our goodwill. So for partial goodwill impairment we must work with our carrying value and our recoverable value. Thus we factor in the 80% you see above.

Also note: Perhaps strictly the workings should be to the nearest $0.1m. But space is a factor in the presentation of the above!

Group position statement

Non-current assets	
Goodwill (10 + 59)	69
Property plant and equipment	
[1869-56para1 +10FVA +22FVA -2.72para5]	1842
Financial assets [138 -7.9para4]	130
Defined benefit asset	38
Current assets	2126
	4205
Share capital	1120
Retained earnings	968
Other components of equity	92
Non-controlling interest	343
Non-current liabilities	851
Current liabilities (786+45para6)	831
	4205

(2 marks: 1 for adding across in cl & ncl plus 1 mark for share capital on b/s!!)

NCI

		Data		*Captive*	
Acquisition		395		105.2	
Growth	[154(40%)]	61.6	[100(20%)]	20	
		456.6		125.2	
Transfer	[456.6(20%/40%)]	(228.3)			
		228.3			
Impairment (above)		(10)			
NCI		218.3		125.2	343

(2 marks: 1 mark each NCI on top of marks below for transfer)

Net effect of transfer

Transfer in	228.3
Consideration out	(220)
Net effect on OCE	8.3

(2 marks for net effect on OCE)

Paragraph 4

Impairment of financial assets uses the original discount rate for the recoverable amount.

Year	cf	df	pv
1	8	0.937	7.498
2	8	0.878	7.027
3	8	0.823	6.586
Present value of recoverable amount			21.1
Carrying value			29
Impairment β {balance}			(7.9)
Recoverable value			21.1

(3 marks: 1 for rate, 1 for DCF & 1 for imp as balance)

Paragraph 5

The compound asset must be broken into its parts.

	Total	roof	building
Cost	50	5	45(balance)
Residual value			(2)
Depreciable amount		5	43
Years		5years	25years
Depreciation	2.72	1	1.72

(3 marks: 1 for split, 1 for residual & 1 for depn)

Paragraph 6

This paragraph makes reference to the corridor which is now off syllabus following a change in IAS19.

Opening corridor (10%)(250)	25
Opening unrecognised loss	22
Excess of loss over corridor	nil

Conclusion: there is no release of unrecognised loss.

This paragraph makes the pension accounting difficult to picture as it deals in the net pension asset and gives insufficient detail to really see what is going on in the asset or liability individually.

Net pension asset

Opening (250-200)	50	
Combined cost	(55)	to be recorded in i/s & RE
Contribution in	45	to be recoded in cl
Current year net actual gain (22-20)	2	recorded already
Actual closing	42	
Asset write off (balance)	(24)	to be recoded in i/s & RE
Recorded closing limited to Asset ceiling	18	
Closing unrecognised loss	20	
Closing combined asset	38	

(4 marks: 2 for movement, 1 for ceiling & 1 for contribution in cl)

Reserves	*RE*	*OCE*
Parent	1066	60
(2) Land {the land should be in i/s not b/s}	(56)	
(3) Goodwill impairment [40+61]	(101)	
(4) FA impairment	(7.9)	
(5) Depreciation	(2.72)	
(6) Unrecorded combined cost	(55)	
(6) Asset write off	(24)	
Data		
11(60%)		6.6
143(60%)	85.8	
Captive		
21(80%)		16.8
79(80%)	63.2	
Net effect of transfer (228.3-220)		8.3
	968.38	91.7

(9 marks: 6 for RE & 3 for OCE: 1 mark per line restricted to max)

(b) Marking guide

1 mark per point.

IFRS8

IFRS8 applies the management philosophy. This means that the management should communicate to their shareholders through the segmental report using the same logic as is applied to segmental information used internally. This even applies to the allocation of costs.

Conclusion

So if management segmental reports exclude common costs, then fs segment reports should exclude common costs. If management segmental reports allocate based on head count, then fs segment reports should allocate based on head count.

Comment

And we do not know what Traveler does with its common costs internally. So all I can do is make recommendations for segmental allocation.

Management expenses

I would suggest that these are allocated based on the hours that management spend working on each segment. So if management spend equal time on each segment then the management expenses should be split equally.

Pension expense

There should be no need for guesswork here. Personnel will know who gets what pension and in which segment they work. Pension should be allocated directly.

Managing properties

I suggest this is simply allocated based on the ratio of the values of property in each segment.

Interest and interest bearing assets

I am guessing that the interest is interest income on the interest bearing assets. Personally I can see no value to allocating these between the segments. It seems to me that any allocation would be entirely arbitrary and not very meaningful.

Consistency

IFRS8 is so obsessed by the management philosophy that policies applied to fs segmental reports should be consistent with management segmental report even if those policies are inconsistent with group fs policies or even IFRS. However, the segmental reports must be reconciled to the fs. So most groups use management segmental reporting policies that do accord with the group policies and IFRS in order to keep reconciliation problems down.

(c) Marking guide

Usual 1 mark per valid point plus 2 marks for clarity and expression.

Scenario and requirement

The scenario and the requirement seem to be referring to two different things; CSR disclosure in the commentary and the CSR of fr in the fs. I will look at the requirement directly first and the issues raised in the scenario second.

Corporate social responsibility disclosure (CSR disclosure)

Annual reports have two components; the fs and the commentary. CSR disclosure appears in the commentary. It is the component of the commentary that the company uses to talk about the relationship of the company with the environment, employees and society as a whole.

Shareholder expectations

It is difficult to talk about the above as if the shareholders all thought the same way. In reality there will be a different expectation for every shareholder. But perhaps it is reasonable to suggest that the thing most shareholders want is a rise in share price.

Conflict

The conflict arises in CSR disclosure because the shareholders probably want to hear about cost savings and hard money issues. But the CSR disclosure will inevitably have to be a softer report talking about the investment in people and the environment.

CSR of fr

But the scenario refers to the very different idea of corporate social responsibility in financial reporting. This is the simple idea that fs must show a true and fair view and that corporations have a responsibility to society to make sure that happens.

Shareholder expectations

As mentioned, it is difficult to generalise about all shareholders. But perhaps it is reasonable to suggest that most are hoping for the highest possible profit.

Conflict

Hence the conflict. The shareholders want to hear about high profits and the directors want to tell about high profits, but the fs are supposed to show a true and fair view. The result is policy selections that often drift away from the truest and fairest view.

Example

A classic example is revaluation. There is no do doubt that revaluation best communicates value on the position statement. But few companies adopt this policy because it reduces profit.

Answer 63 Decany

This was a focus question based upon focus on group reorganisation with a hint of entity reconstruction. The question is essentially a list of instructions to be turned into double entry and put through the books of the individual entities. The instructions are very silly but not particularly difficult. In fact, if you can think double entry in your head, then you will be able to adjust the balance sheets without writing out the journals in full. This is the approach the examiner took.

But regardless of the approach to this question, you would have to be brilliant at double entry and spectacularly quick thinking to get anywhere with this question in the exam.

(a)(i) Journals

As mentioned above, the journals are not strictly necessary to the answer to this question. But they do help keep a track of the plan.

Point 1

Ceed purchase

Dr	Investment in Rant	98
Cr	Bank	98

Decany sale

Dr	Bank	98
Cr	Investment in Rant	95
Cr	Profit on sale (I/S & RE)	3

Decany loan

Dr	Rant receivable	98
Cr	Bank	98

Rant cash injection

Dr	Bank	98
Cr	Decany payable	98

Point 2

Ceed purchase

Dr	Land	15
Cr	Mortgage	4
Cr	Share capital (nominal)	5
Cr	Share capital (premium){balance}	6

Rant sale

Dr	Investment in Ceed	11
Dr	Mortgage	4
Cr	Land	10
Cr	Profit on disposal (RE)	5

Point 3

Ceed payment

Dr	Dividend paid (SOCIE & RE)	25
Cr	Bank	25

Decany receipt

Dr	Bank	25
Cr	Dividend Received (I/S & RE)	25

Redundancy

Year	CF	DF	PV
1	4	0.97	3.9
2	6	0.94	5.7

Ceed provision

Dr	Cost (I/S & RE)	9.6
Cr	Provision (CL)	3.9
Cr	Provision (NCL)	5.7

Restructure

Decany cost

Dr	Cost (I/S & RE)	2
Cr	Provision	2

Comment

Like any question on double entry, there are other ways to interpret the journals, which would be acceptable. For example, you may have interpreted the restructure cost as paid "after the proposed restructuring plan" to quote the requirement.

Decany

	before	1	2	3	restruct	after
NCA	600					600
Inv(Ceed)	130					130
Inv(Rant)	95	-95				0
CA	155	+98-98+98		+25		278
	980					1008
SC	140					140
RE	750	+3		+25	-2	776
NCL	5					5
CL	85				+2	87
	980					1008

Ceed

	before	1	2	3	redund	after
NCA	170		+15			185
Inv(Ceed)						
Inv(Rant)		+98				98
CA	130	-98		-25		7
	300					290
SC	70		+5+6			81
RE	220			-25	-9.6	185.4
NCL			+4		+5.7	9.7
CL	10				+3.9	13.9
	300					290

Rant

	before	1	2	3	after
NCA	45		-10		35
Inv(Ceed)	0		+11		11
Inv(Rant)					
CA	20	+98			118
	65				164
SC	35				35
RE	5		+5		10
NCL	12		-4		8
CL	13	+98			111
	65				164

(a)(ii) Comment

This requirement is technical beyond belief. Very few students even had a clue what they were being asked. Even the length of the answer is ridiculous for 5 marks.

Marking guide

Theoretically 1 mark per point.

IAS27 regarding dividends

IAS27 makes it crystal clear that post acquisition dividends from any sub are recorded by the parent in the income statement as dividend income.

Pre and Post acquisition dividends

The above may seem completely obvious, but it was written into the IAS to prevent a nonsense that used to be recorded in the 1990s. the nonsense involved pretending that part of the post acquisition dividend was pre acquisition and then using this pre acquisition element to reduce the cost of the investment.

Application to Decany

The $25m dividend from Ceed to Decany must be recorded by Decany in the i/s in full. It is not necessary or even permitted to start thinking about pre acquisition elements and then reducing the cost of investment of $130m.

IAS27 regarding group reorganisation

Specified accounting applies in separate financial statements when a parent reorganises the structure of its group by establishing a new entity as its parent in a manner satisfying the following criteria:

(1) Equity swap

The new parent obtains control of the original parent by issuing equity instruments in exchange for existing equity instruments of the original parent

(2) Unchanged group

The assets and liabilities of the new group and the original group are the same immediately before and after the reorganisation, and

(3) Unchanged owners

The owners of the original parent before the reorganisation have the same absolute and relative interests in the net assets of the original group and the new group immediately before and after the reorganisation.

Where these criteria are met, and the new parent accounts for its investment in the original parent at cost, the new parent measures the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganisation.

Application of original cost rule

The above requirements:

(x) Intermediate parent

Apply to the establishment of an intermediate parent within a group, as well as establishment of a new ultimate parent of a group.

(y) New parent

Apply to an entity that is not a parent entity and establishes a parent in a manner that satisfies the above criteria.

(z) Common control transactions

Apply only where the criteria above are satisfied and do not apply to other types of reorganisations or for common control transactions more broadly.

Application to Decany Group

At first it appears the original cost rule applies to the transaction in point 1. Ceed becomes an intermediate parent as given in (x). Also the original owner (Decany) of Rant owns Rant absolutely before and after the transaction. So condition (3) unchanged owners is fulfilled. Also the group has the same assets and liabilities before and after. So condition (2) unchanged group is fulfilled. But the transaction is not an equity swap. Ceed pays cash. So the original cost rule does not apply and Ceed recognises the new cost of $98m rather than the original cost of $95m.

(b) Marking guide

Usual 1 mark per valid point

Group reorganisation

The plan represents a classic group reorganisation. The reorganisation is the purchase of Rant by Ceed. This is a classic group reorganisation called "simple group to vertical group".

Group implications

The implications of all group reorganisations are the same. Group reorganisations have no effect on group fs. The group has the same assets and liabilities before and after point 1 is transacted.

Entity reconstruction

There is a flavour of entity reconstruction in this question as well. After all, the plan was motivated by a desire to get Rant out of trouble.

Complex

The plan is breathtakingly complex. Money and shares and other assets are flying through the entities with no apparent logic. Transaction 2 is daft beyond belief. The group takes useful land of a struggling sub and gives useless shares in a fellow sub in exchange. Truly bizarre.

Recommendation

I recommend that the group do not execute their plan. I recommend that Decany simply lends cash to Rant and helps Rant through its troubles.

Answer 64 Scramble

This was a relatively challenging industry question requiring the application of a mix of standards, with a heavy leaning towards intangibles and IAS38. As usual the IAS numbers themselves are not required. If you know a standard number, then feel free to use it; but do not guess.

The marking guide throughout was a simple "1 mark per point". So as usual, very different answers to this question could score full marks.

(a) Intangibles (IAS38)

The accounting of intangibles is split into two parts in IAS38. There is development and other intangibles.

Other intangibles

These are only recognised if measurable and only measureable if purchased. The Scramble asset is internally developed. So cannot be capitalised through this route.

Development

Development costs are internal. These can be capitalised if recoverable. The test for recoverability can be remembered using a mnemonic:-

D defined intention and ability to complete

E expenditure measureable and attributable

F feasible technically

E economic benefit

R resources adequate.

Scramble

Scramble appears to be using this route for capitalisation and if the defer criteria are fulfilled then the development costs can be deferred.

Maintenance

This has been written off. This follows the idea of revenue expenditure. Expenditure to maintain operating capacity must be written off.

Historical cost

Scramble is right to use historical cost. In theory IAS38 allows a revaluation policy for intangibles, but that is only permitted if the subsequent valuations can be supported by an active market. This means there must be a market of exact equivalent assets. This does happen with such rare intangibles as energy trading rights. These rights are all exactly the same and have active world markets with public exchange prices. But the effect of the active market rule is that very few intangibles can be revalued.

Life

I do not know much about computer games, but as far as I can tell from the adverts I have seen around London, computer games are constantly being superseded. So Call of Duty 1 is replaced by Call of Duty 2 and so on. So my guess is that the lives would be very short; maybe three years. So the games should be depreciated over their lives.

Impairment

Again I am guessing here, but I would think that the risk of a game falling out of favour at any point would be quite high. So I suggest that Scramble should perform an impairment test on all the games at every year end. An impairment occurs if recoverable value falls below carrying value.

VIU

Recoverable value is the higher of value in use (VIU) and fair value less costs to sell (FVLCTS). Scramble seems to have ignored the FVLCTS. I suspect this is reasonable as I imagine most games being far more profitable in use than in sale. So Scramble has focussed on VIU and based this upon discounted cash flow forecasts (DCF).

CFF

But there are problems with the way that the cash flow forecasts (CFF) have been done. First the CFF must be the best estimate possible. But Scramble CFF could be better. Scramble CFF could be improved by the investigation of differences between expected and actual that the scenario talks about. So Scramble should start doing this. Also the CFF should exclude tax for the purpose of VIU.

(b) Materiality

The statistics at the start of the scenario (90%, 63% & 29%) are simply telling us that the problems in the CGUs are highly material and need calculating appropriately and then disclosing usefully.

Impairment

As mentioned above, an impairment occurs if recoverable value falls below carrying value. Recoverable value is the higher of value in use (VIU) and fair value less costs to sale (FVLCTS).

VIU

I can see that FVLCTS might be tiny in this industry and so I can see that VIU might be the higher in all circumstances. So Scramble's focus on VIU seems reasonable. As mentioned above, VIU applies discounting to cash flow forecasts (CFF) in a process known as discounted cash flow (DCF).

Discount rate

It is a basic rule of financial management that the discount rate used to assess a project should be the discount rate appropriate for the project. So a supermarket project financed by a HSBC loan should be assessed by using supermarket discount rates and not HSBC loan rates.

Scramble

So Scramble should use discount rates appropriate to gaming software to discount the CFF in the gaming software CGUs. Scramble should not use the finance interest rates.

CAPM

So Scramble should use a model like the Capital Asset Pricing Model to estimate an appropriate discount rate for the industry.

Effect

The effect is likely to be profound. The industry discount rate (maybe 20%) is likely to be much higher than the finance interest rate (maybe 5%). And so the present value (PV) derived from discounted cash flow (DCF) is likely to be much lower.

Disclosure

The final point comes down to disclosure. Once Scramble has redone its impairment tests and calculated new appropriate impairments for the two CGUs then these must both be clearly disclosed in the fs. The impairment itself would be separately disclosed on the i/s and the detail would be explained in the notes (sometimes known as "superexceptional" disclosure under IAS1). The statistics discussed in my opening paragraph tell us that shareholders will want to know what happened.

(c) Business combination (IFRS3)

The scenario does not tell us whether the football club is incorporated. But it does not matter. The football club is a business. So the purchase would be accounted for as a business combination and goodwill would be calculated as usual.

Intangibles

An intangible is recognised if measurable and an intangible is considered measureable if the intangible is purchased.

Football players in Rashing fs

The football players were purchased by Rashing and so should be recognised by Rashing. The football players should be recognised at historical cost less depreciation over the contract lives and impairment for injuries.

Football players in Scramble fs

Essentially the same accounting will apply in Scramble fs. But Scramble will be required to recognise the football players at the fair value at the point of purchase of Rashing by Scramble. Fair value adjustments (FVAs) may be required.

PPA

It sounds like Rashing has until recently written off the purchase of football players at purchase. This is wrong now and was wrong at the time. So it sounds like a prior period adjustment (PPA) will be required to restate the figures to get them how they always should have been.

Agents' fees

The initial cost of the intangible should be all the direct costs in bringing the asset into use. The idea is essentially the same for tangibles and intangibles. So the agents' fees should be capitalised along with the registration fee itself. This applies equally for the initial transfer and the extensions.

Santash

The Santash deal sounds very unusual. It is hard to say what is going on without seeing the contract itself and getting a better feel for the real story. But it appears that only one answer is possible.

Intangible asset

It appears the deal is not an intangible, as Rashing has no control over the asset.

Financial asset

All Rashing has is the right to cash. So Rashing should recognise a financial asset (and Santash should recognise a financial liability).

Loan asset

At first it looks like this deal may in substance be a loan. It could be that the deal has been set up so that effectively Rashing is lending Santash the original cash flow and then repayment comes in the form of the 25% revenue stream. But a loan asset is properly called a financial asset at amortised cost and two tests must be fulfilled under IFRS9.

FVTPL (IFRS9)

It is hard to say for sure, but maybe at least one test in IFRS9 is unfulfilled (CF characteristics and business model). The cash flows are likely to be so variable that they cannot be said to be principal plus interest. Also the asset maybe held for eventual sale. So maybe the financial asset would be carried at fair value and the gains would default into the profit or loss (FVTPL).

Answer 65 Venue

This was a lovely current issues question on revenue, looking more at the problems in current revenue recognition and not so much on the proposals.

Marking guide

Of course, the usual 1 mark per idea applies.

(a)(i) Standards

The first problem is that there are multiple standards on revenue under IFRS. There is the central IAS18, but there are others too:-

IAS11 construction revenue

IAS17 lease revenue

IFRS9 speculation revenue

Inconsistency

The result is inconsistency. Two companies with similar revenue streams may use different IFRS and so have different revenue recognition. For example one company doing restoration may see that is similar to construction and use IAS11. Another company doing restoration may use basic IAS18.

USA

The problem of multiple revenue standards is bad under IFRS but worse under US FRS (FAS) where there are over one hundred guidance documents on revenue.

IAS18

IAS18 has two models for revenue:

Sale of goods

This is recognised at the point that risks and rewards transfer.

Sale of services

This is recognised over the period and so in proportion with completion.

Inconsistency again

The problem of inconsistency raises its head again. Two companies with similar revenue may use different models.

Example

So for example, one TV programme maker might interpret making a TV programme as the sale of intellectual property goods. Another TV programme maker might interpret making a TV programme as the provision of a service.

The point

When we get into the "at" model for goods, we find more problems. Risks and rewards is highly subjective and so different accountants might have different sale points for similar goods.

Example

So the sale of ship might be at the point that the ship is delivered or at the point that the customer quality control is completed, depending on how the risks and rewards are interpreted.

Control

By the way, the "at" model for goods is also inconsistent with the framework for fr. The framework requires the recognition of an asset at the point that control transfers. Whereas as we have just seen, the revenue guidance requires the recognition of an asset at the point that risks and rewards transfer.

The period

A similar problem arises with the "over" model for services. The period of a service and the degree of completion at any point in that period is highly subjective.

Example

When projects are part completed there are often a number of competing percentages of completion, from directors surveyors and customers.

Unbundling

Another problem in IAS18 related to unbundling. Unbundling is the process of splitting a compound transaction down into its component parts. IAS18 requires unbundling, but does not say how or when.

Discounting

A similar problem arises with discounting. Discounting is the process of accommodating the time value of money. IAS18 gives no guidance at all in this area, but discounting is implied by other IFRS.

Conclusion

From the above it is easy to see that there is a mass of subjectivity in current guidance on revenue. Given that revenue is usually the biggest single figure in most fs, it is understandable that the IASB are seeking to improve the guidance in this area.

(a)(ii)Credit Risk

Credit risk is the risk that the customer may not pay. It is the risk that a receivable may result in a bad debt.

Bad debts and bad sales

There is under current financial reporting a distinction between bad debts and bad sales. Bad debts occur when a good sale has taken place but the customer has not paid. It is formally known as the impairment of a receivable. But a bad sale occurs when the company sells to a customer that was never likely to pay. This is currently accounted for by derecognition of the sale instead of impairment of the receivable.

Proposal

It is accepted that this model makes sense. So there is a proposal to retain this idea in the new revenue guidance by keeping credit risk in proposed revenue recognition. But the contentious part of the revenue proposals relates to recognising only part of a sale if there is a significant chance of receiving none of the cash. This contentious proposal would radically change selling to new unknown credit customers.

Time value of money

Many sales result in trade receivables that have short lives before being due for payment. Thus the time value of money is immaterial for most trade receivables. This is why old IAS18 gave little explanation to the time value of money.

Financial assets

But all trade receivables are receivables. And all receivables are financial assets. And financial assets at amortised cost must be recognised at an initial fair value based on discounting at the effective rate. We ignore this for most trade receivables because of materiality as discussed. But the requirement remains.

Long life receivables

However, of course long life receivables do occur. And obviously those receivables should be discounted. Hence proposed revenue guidance will include guidance on discounting.

(b)(i) Time value

One month is immaterial. The time value of money can be ignored.

Credit risk

But credit risk of 5% is sizeable. But this too is ignored.

Impairment of financial assets

Current guidance on credit risk is that an impairment can only be recognised if two criteria are fulfilled:-

O objective evidence

R recoverable amount

Point of sale

At the point of sale there is no objective evidence of an impairment. So the sale would be recorded at the full $1m. Only later, when the objective evidence of trouble arrives, does Venue recognise the $100k impairment.

(b)(ii)Time value

Clearly with time differences measured in years, the time value of money should be factored in the accounting. This requirement comes from IFRS9 and guidance on receivables and not so much from IAS18 and guidance on revenue.

Sale

The discount factor for 4% after two years is applied to the sale:-

Initial receivable = (0.924)($2m)

= $1.849m

Unwinding

The asset is then unwound back up to its original value of $2m by recording interest income over the two years.

Purchase

For the purchase, Venue receives the money now. The present value of $3m now, is of course $3m:-

Initial payable = $3m

This is effectively recognising a short term loan.

Unwinding

The payable is then unwound over the one year by recording an interest expense at 4% to give a purchase of $3.12m. The purchase itself is recognised at delivery.