QUESTION 47 Key (Q2 December 2009)

(a) Key, a public limited company, is concerned about the reduction in the general availability of credit and the sudden tightening of the conditions required to obtain a loan from banks. There has been a reduction in credit availability and a rise in interest rates. It seems as though there has ceased to be a clear relationship between interest rates and credit availability, and lenders and investors are seeking less risky investments. The directors are trying to determine the practical implications for the financial statements particularly because of large write downs of assets in the banking sector, tightening of credit conditions, and falling sales and asset prices. They are particularly concerned about the impairment of assets and the market inputs to be used in impairment testing. They are afraid that they may experience significant impairment charges in the coming financial year. They are unsure as to how they should test for impairment and any considerations which should be taken into account.

Required:

Discuss the main considerations that the company should take into account when impairment testing non-current assets in the above economic climate. (8 marks)

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

(b) There are specific assets on which the company wishes to seek advice. The company holds certain non-current assets, which are in a development area and carried at cost less depreciation. These assets cost $3 million on 1 June 2008 and are depreciated on the straight-line basis over their useful life of five years. An impairment review was carried out on 31 May 2009 and the projected cash flows relating to these assets were as follows:

Year to	**31 May 2010**	**31 May 2011**	**31 May 2012**	**31May 2013**
Cash flows ($000)	280	450	500	550

The company used a discount rate of 5%. At 30 November 2009, the directors used the same cash flow projections and noticed that the resultant value in use was above the carrying amount of the assets and wished to reverse any impairment loss calculated at 31 May 2009. The government has indicated that it may compensate the company for any loss in value of the assets up to 20% of the impairment loss.

Key holds a non-current asset, which was purchased for $10 million on 1 December 2006 with an expected useful life of 10 years. On 1 December 2008, it was revalued to $8.8 million. At 30 November 2009, the asset was reviewed for impairment and written down to its recoverable amount of $5.5 million.

Key committed itself at the beginning of the financial year to selling a property that is being under-utilised following the economic downturn. As a result of the economic downturn, the property was not sold by the end of the year. The asst was actively marketed but there were no reasonable offers to purchase the asset. Key is hoping that the economic downturn will change in the future and therefore has not reduced the price of the asset.

Required:

Discuss, with suitable computations, how to account for any potential impairment of the above non-current assets in the financial statements for the year ended 30 November 2009. (15 marks)

(Total: 25 marks)

QUESTION 48 Burley (Q3 December 2009)

Burley, a public limited company, operates in the energy industry. It has entered into several arrangements with other entities as follows:

(i) Burley and Slite, a public limited company, jointly control an oilfield. Burley has a 60% interest and Slite a 40% interest and the companies are entitled to extract oil in these proportions. An agreement was signed on 1 December 2008, which allowed for the net cash settlement of any over/under extraction by one company. The net cash settlement would be at the market price of oil at the date of settlement. Both parties have used this method of settlement before. 200,000 barrels of oil were produced up to 1 October 2009 but none were produced after this up to 30 November 2009 due to production difficulties. The oil was all sold to third parties at $100 per barrel. Burley has extracted 10,000 barrels more than the company's quota and Slite has under extracted by the same amount. The market price of oil at the year-end of 30 November 2009 was $105 per barrel. The excess oil extracted by Burley was settled on 12 December 2009 under the terms of the agreement at $95 per barrel.

Burley had purchased oil from another supplier because of the production difficulties at $98 per barrel and has oil inventory of 5,000 barrels at the year-end, purchased from this source. Slite had no inventory of oil. Neither company had oil inventory at 1 December 2008. Selling costs are $2 per barrel.

Burley wishes to know how to account for the recognition of revenue, the excess oil extracted and the oil inventory at the year-end. (10 marks)

(ii) Burley also entered into an agreement with Jorge and Heavy, both public limited companies on 1 December 2008. Each of the companies holds one third of the equity in an entity, Wells, a public limited company, which operates offshore oilrigs. Any decisions regarding the operating and financial policies relating to Wells have to be approved by two thirds of the venturers. Burley wants to account for the interest in the entity by using proportionate consolidation, and wishes advice on the matter.

The oilrigs of Wells started operating on 1 December 1998 and are measured under the cost model. The useful life of the rigs is 40 years. The initial cost of the rigs was $240 million, which included decommissioning costs (discounted) of $20 million. At 1 December 2008, the carrying amount of the decommissioning liability has grown to $32.6 million, but the net present value of decommissioning liability has decreased to $18.5 million as a result of the increase in the risk-adjusted discount rate from 5% to 7%. Burley is unsure how to account for the oilrigs in the financial statements of Wells for the year ended 30 November 2009.

Burley owns a 10% interest in a pipeline, which is used to transport the oil from the offshore oilrig to a refinery on the land. Burley has joint control over the pipeline and has to pay its share of the maintenance costs. Burley has the right to use 10% of the capacity of the pipeline. Burley wishes to show the pipeline as an investment in its financial statements to 30 November 2009.

(9 marks)

(iii) Burley has purchased a transferable interest in an oil exploration licence. Initial surveys of the region designated for exploration indicate that there are substantial oil deposits present but further surveys will be required in order to establish the nature and extent of the deposits. Burley also has to determine whether the extraction of the oil is commercially viable. Past experience has shown that the licence can increase substantially in value if further information as to the viability of the extraction of the oil becomes available. Burley wishes to capitalise the cost of the licence but is unsure as to whether the accounting policy is compliant with International Financial Reporting Standards. (4 marks)

Professional marks will be awarded in question 3 for clarity and expression. (2 marks)

Required:

Discuss, with suitable computations where necessary, how the above arrangements and events would be accounted for in the financial statements of Burley.

(Total: 25 marks)

QUESTION 49 FI (Q4 December 2009)

The definition of a financial instrument captures a wide variety of assets and liabilities including cash, evidence of an ownership interest in an entity, or a contractual right to receive, or deliver cash or another financial instrument. Preparers, auditors and users of financial statements have found the requirements for reporting financial assets and liabilities to be very complex, problematical and sometimes subjective. The result is that there is a need to develop new standards of reporting for financial instruments that are principle-based and significantly less complex than current requirements. It is important that a standard in this area should allow users to understand the economic substance of the transaction and preparers to properly apply generally accepted accounting principles.

Required:

(a) (i) **Discuss how the measurement of financial instruments under International Financial Reporting Standards can allow users to understand the economic substance of the transaction and preparers to properly apply generally accepted accounting principles.** (13 marks)

(ii) **Set out the reasons why using fair value to measure all financial instruments may result in less complexity in financial reporting but may lead to uncertainty in financial statements.** (5 marks)

Professional marks in part (a) for clarity and expression. (2 marks)

(b) A company borrowed $47 million on 1 December 2008 when the market and effective interest rate was 5%. On 30 November 2009, the company borrowed an additional $45 million when the current market and effective interest rate was 7.4%. Both financial liabilities are repayable on 30 November 2013 and are single payment notes, whereby interest and capital are repaid on that date.

Required:

Discuss the accounting for the above financial liabilities under current accounting standards using amortised cost, and additionally using fair value as at 30 November 2009. (5 marks)

(Total: 25 marks)

Answer46: GRANGE

NET ASSETS	P		F	
	Acq	YE	Acq	YE
SC	230	230	150	150
RE	115	170	73	65
OCE	10	14	9	17
FVA (Franchise)[depn= $10m(1.5yr/5yr)]	10	7	-	-
FVA (Contingency)	-	-	(30)	(25)
FVA (PPE)[depn=$4m(1.33yr/10yr)]	-	-	4	3.47
	(360+10)370	426	(202 + 4)206	210
Growth		56		4

Note that both FVAs above suffer depreciation following aquistion. The franchise FVA depreciation is fairly easy as the acquisition was literally in the middle of the year. But the PPE FVA depreciation is very messy. The acquisition was 4 months before the year start (0.33years). so the resulting depreciation is roughly $0.53m.

GOODWILL	%	Working	P	%	Working	F
FV of Consideration	60%		250	100%		214
FV or NCI	40%		150			
FV of NA			(370)			206
Goodwill			30			8

TRANSFER (i) FROM NCI TO CI

	Acq	Growth	
NCI Before	{150+	40% (56)}	172.4
Transfer (172.4)(20% / 40%)			(86.2)
NCI After (shown as nci in b/s)			86.2

EFFECT

Transfer IN	86.2
Transfer OUT	(90)
Effect on OCE	(3.8)

Note that the examiner uses a proportion of nci for this transfer.

TRANSFER (ii) FROM CI TO NCI

Carrying Value	(NA + GW) 210 + 8	218
Percentage		25%
Transfer Out (to nci and therefore shown as nci in b/s)		54.5

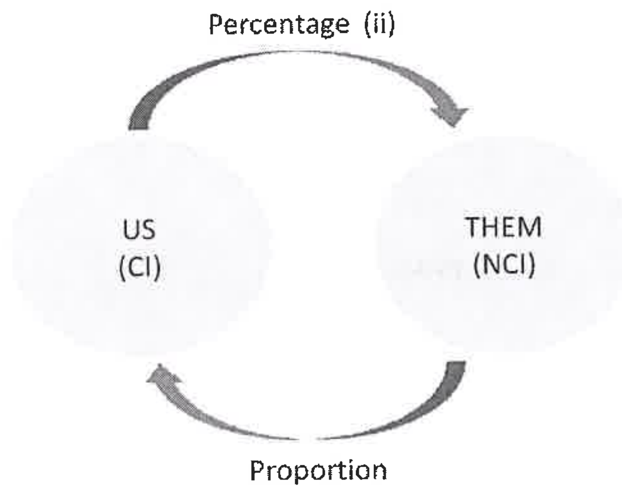
EFFECT

Transfer OUT	(54.5)
Consideration IN	80
Effect on OCE	25.5

Note that the examiner uses a percentage of the whole sub for this transfer.

TRANSFERS

The examiner has an inconsistent approach to transfers:



GROUP POSITION STATEMENT (answer (a))		**$m**
Non Current Assets		
Goodwill (30 + 8)		38
Property, Plant and Equipment	[806 + 5FVA + 3.47FVA – 6(iv) + 4(vi) - 32(vii)]	780
Intangible [FVA]		7
Associate [(iii) fair value of residual]		13
Investment Property (iv)		8
Current Assets (920)		920
		1766
Equity		
Share Capital		430
Retained Earnings		408
Other components of Equity	[22 – 3.8(i) + 25.5(ii) + 4(vi) – 1(ii) transfer out]	47
Non Controlling Interest	(86.2 + 54.5){see transfers above}	141
Non Current Liabilities (334)		334
Current Liabilities		
Trade and other payables (345)		354
Provision for liabilities	[20 + 25(FVA) + 7]	52
		1766

WORKING (iii) Associate (answer (b))

At the year end the sale of 60% results in the loss of control of the former sub which becomes an associate for the last few hours of the year because of the influence retained by the 40% ownership.

Goodwill

FV of consideration 100%	39
FV of NCI	-
FV of NA	(32)
Goodwill	7

Disposal

Actual sales proceeds (60%)	23
Deemed sales proceeds (40%){fair value of residual}	13
NCI	-
NA	(36)
GW (39 – 32)	(7)
Loss on disposal	(7)

Working (iv) Investment Property

It is not clear, but it appears the land is an investment property incorrectly thrown in with the ppe. So the $6m must be moved from ppe to ip and then fair valued at $8m with a gain of $2m to i/s.

	$m
Opening 8m dinars / 2	4
Revaluation (to RE and I/S){balance}	4
Closing 12m dinars / 1.5	8

Working (v)

Grange must provide for the fine as it will be fined. Grange must provide for the compensation as it will have to pay. But Grange must not provide for the chages in manufacturing as they have only been requested and so there is no obligation.

WORKING (vi) Property Plant and Equipment

This paragraph is very similar to paragraph (iv). Again it is not crystal clear, but it does appear that this property is correctly classified as ppe. So this property stays in ppe and we put through a ppe revaluation.

Property	$m
Opening 8m dinars / 2	4
Revaluation (to OCE and OCI){balance}	4
Closing 12m dinars / 1.5	8

WORKING (vii)

Parent Impairment

The reorganisation has not been carried out. So the current VIU is the $830m. the scenario tells us that this is the recoverable value before reorganisation. The following approximates to the impairment of the parent CGU:-

Carrying value (Equity = NA)	862
Impairment (to IS + PPE)	(32)
Recoverable value (VIU)	830

Parent provision

Grange cannot provide for the $30m reorganisation as they have not approved it. They have commissioned further work prior to approval. They are only thinking about reorganisation. The announcement can only mean they have announced they are thinking about a reorganisation. That is because they are only thinking about a reorganisation. So unless they are out and out liars, directors must have announced they are thinking about reorganisation. This, of course, incurs no obligation. This logic is backed up by IAS37 which absolutely requires that a reorganisation provision is supported by a detailed formal(approved) plan as well as the usual announcement criteria.

RE		**$m**
Parent		410
(iii)	Profit on disposal	(7)
(iii)	Associate: Income statement growth (3) (100%)	3
(iii)	Associate: Transfer in from strategic equity reserve in OCE	1
(iv)	Investment property revaluation	2
(v)	Fine $1m and compensation $6m	(7)
(vi)	PPE revaluation	-
(vii)	Payment impairment	(32)
P	56*(60%)	33.6
F	4*(100%)	4
		407.6

Note that the transfer out of OCE and into RE in paragraph (iii) is incredibly subtle. You may have seen that the former sub Sitin made OCE gains during the period of control. Now we have lost control of that sub the gain of $1m moves from OCE to RE as it is considered realised.

Answer 47 Key
Marking guide
Usual marking guide of 1 mark for 1 point well made.

(a) Impairment

An impairment occurs when the recoverable value of an non-current asset falls below the carrying value.

Recoverable value

This is the higher of value in use and fair value less costs to sell.

Value in use (VIU)

As the name suggests, value in use (VIU) measures the net present value of the asset using the principles of discounted cash flow (DCF) derived from financial management.

Fair value less costs to sell (FVLCTS)

The above is also literal. It is the cash expected to derive from immediate sale as implied by market value less the costs required to achieve that sale. It essentially synonymous with net realisable value (NRV).

Cash generating unit

Ideally impairment tests should be done on an asset by asset basis. But in practice this is often impossible as many assets do not have individual VIU. So the impairment test is done on the smallest unit possible called the cash generating unit.

Impairment test

This is required when there are indications of impairment.

Credit conditions

Which brings us to the scenario. The scenario is describing the start of a recession. This is effectively an indication of impairment for all the nca in the group. It does not mean all assets will have suffered an impairment. It just means they must be tested.

NRV

But of course the tightening of credit is likely to make the sale all the harder. Thus the fair value is likely to be hit. So NRV will be down.

VIU

Further demand will hit the cash flows in the DCF and those cash flows will be hit again by a harder higher discount rate. This is likely to reduce VIU.

Effect

So in summary, the recession will result in widespread impairment reviews that are more likely to reveal an impairment.

(b) Development area

The carrying value is as follows:

	$k
Cost	3,000
Depreciation	(600)
Carrying value	2,400

DCF

The dcf reveals the following:

Year	cf	df	pv
1	280	0.9524	
2	450	0.9070	
3	500	0.8638	
4	550	0.8227	
VIU			1,558

NRV

There is no information on fair value less costs to sell (FVLCTS). But it is usually the case that this is below VIU.

Impairment

So on the assumption that VIU is the higher, the following would be recorded;

	$k
Carrying value	2,400
Impairment (balance)	(842)
Recoverable value	1,558

Recognition

The impairment loss would go through the income statement and may be separately recorded on the i/s as a superexceptional item.

Reversal

It is quite possible that the above projected cash flows could give a higher VIU at a second impairment test at the year end. However, given the undiscounted sum of the cash flows is $1,780k, the reversal would be only partial and probably quite small.

Accounting

The rule when accounting for reversals is that they go back through the performance statement that accommodated the original movement. In this case the original movement was an impairment and so it has gone through the i/s. so this reversal will also go through the same i/s.

Government compensation

This cash flow may be categorised as a contingent asset. It appears to be a possible contingent asset. I am guessing based on the word "may" in the scenario. Possible contingent assets are ignored.

(6 marks)

Other nca

The other nca also has a reversal. This asset went up then down. The first asset went down then up. But the principles hold true.

Limits

But the amount of a reversal is subject to two limits. (see question Grange for more practice at this).

First limit

Firstly the reversal is limited to the original movement. As you see below the original gain was $0.8m. So this is the maximum reversal.

Second limit

But it is usually the second limit that defines the reversal. Reversals are also limited by the historical NBV. This is the figure that would have been carried had there been only depreciation. As you see below the historical NBV is $7m in this case and this limits the reversal to $0.7m.

Numbers

The numbers on the other nca are like this:

	$m
Cost	10
Two earlier years depreciation	(2)
Opening	8
Revaluation gain (to OCI)	0.8
Value	8.8
Current depreciation (8.8/8years)	(1.1)
Before	7.7
Reversal loss (to OCI){balance}	(0.7)
Historical NBV [10-(3yrs)(1depn)]	7
Impairment (to I/S){balance}	(1.5)
Closing	5.5

(6 marks)

Under-utilised asset

At first this looks like a candidate for nca held for sale.

Criteria

The criteria are as follows:

S sell: clear commitment to sell
A available: ready to go
L locate: actively looking for a purchaser
E expected: sale expected within 12 months.

Fail

But he asset fails the locate test. The directors must be actively seeking to locate a purchaser and this includes asking a price that reasonably reflects the market. Key directors are not doing this. So the nca must stay in nca.

(3 marks)

Answer 48 Burley
Marking guide
The old favourite marking guide of 1 point per point.
Answer commentary
Part (i) is horrible. There is bucket loads of information and even the bizarre idea that the market price for oil ($105) is different from the actual price buyers and sellers are trading ($100). It tells you the importance of doing part (i) last; or even better, not doing this question at all.

(i) Oilfield

It is possible to have joint control with uneven ownership, but it is rare. It is not obvious why Burley would allow Slite such massive influence when Burley has the majority ownership.

IFRS11 Joint Arrangements

The above distinguishes between a joint venture (JV) and a joint operation (JO). They are very similar, but not quite the same.

JV

An arrangement where the venturers have rights to the net assets.

JO

An arrangement where the venturers have rights to the individual assets.

Difference

Like I said, the difference is subtle; but you can see it. In a JO the players can get at the assets directly. In a JV the players can only get at the profits. Fortunately, the difference usually relates to incorporation. JV are incorporated and JO are not.

Conclusion

The oilfield is very obviously a JO. The players go in to the JO and extract their own oil almost like the JO was not there. The players have direct and individual rights to the oil. It also helps that the JO in unincorporated making the conclusion more obvious.

Contrast

This is completely different from a JV which would work completely differently. If the oilfield was a JV then the oilfield would drill its own oil, then sell its oil to the market and give the venturers a return via dividends. You can see this oilfield is doing nothing of the sort.

JO accounting

So Burley will recognise 60% of the oilfield as its own.

Liability

There is a clear agreement between the parties on how much oil can be taken out by each and Burley is over by 10,000 barrels and so owes Slite.

Measurement

There are all sort of different ways to read the scenario as to what Burley owes Slite per barrel at the year end. However, the scenario tells us that "the net settlement would be the market price of the oil at the date of settlement". That is the date of settlement and not the date of extraction. Also the scenario goes on to say "under the terms of the agreement" Burley paid $95 per barrel shortly after the year end. To me it seems to make sense to imply that $95 per barrel was what was owed at the year end.

Journal

So the following journal would result:

Dr Inventory ($95)(10k units)	$950k
Cr Payable	$950k

Post balance sheet event

Of course, you could read the liability as being $105 per barrel (apparent market price at year end) or $100 per barrel (real market price based on sales at year end). I think that is wrong, but you could argue something along those lines. But that would lead to a lot of immaterial messing around with setting up one liability and then hacking down the liability after year end and recording a gain as if speculating on the liability. It would also lead to some fairly weird impairment testing as the oil cost would have to be consistent with the oil liability.

Inventory

Which brings us to the impairment of inventory. The outside purchased oil is fine. The figures appear to be as follows:

Cost	$98 per barrel
NRV	$98 per barrel (100-2)

JO oil

And using the above $95, the JO oil is fine too:

Cost	$95 per barrel (implied from contract)
NRV	$98 per barrel

(ii) Wells

Wells really does sound like a joint arrangement. But it is not.

Joint control

This idea is literal. For joint control to exist there has to be an all or nothing relationship between the venturers called unanimous voting. This can be a nightmare in real life, especially when there are three venturers and two think one thing and the other thinks something else. In a JV this leads to deadlock and gets really nasty.

Two thirds

The two thirds rule in Wells is very practical. But it does mean that there is no joint control.

Associate

What the players have is significant influence and an associate. So associate accounting (equity accounting) is required.

IFRS11

Wells is not a JV. But if Wells was a JV then IFRS11 would require associate accounting anyhow. So in truth it makes no difference if Wells is a JV or an associate.

Oilrig

The oilrig has been correctly accounted for using an initial discounted decommissioning cost and it sounds like the unwinding has been correctly accommodated too.

Liabilities

But decommissioning provisions are just liabilities and sometimes the estimate of a liability changes. So Wells must adjust its liability to the obligation.

	$m
Before	32.6
Adjustment	(14.1)
After	18.5

Original journal

But of course when the liability was originally recognised the following was recorded:

Dr PPE	$20m
Cr Provision	$20m

New journal

So the new journal adjusting for the fall in the provision does the reverse:

Dr Provision	$14.1m
Cr PPE	$14.1m

Depreciation

This has a knock on effect on the rig itself and depreciation:

	$m
Opening (10 of 40 years gone)	180
Above adjustment	(14.1)
Adjusted opening	165.9
Deprecation (30 years left)	(5.5)
Closing	160.4

Unwinding

Quite separately Wells would also unwind the $18.5m liability at 7%.

Pipeline

This is a simple joint operation. Burley has joint control and direct access to the asset. Even that is overcomplication. It is easiest just to say Burley has 10% of a pipeline; so Burley should recognise 10% of a pipeline.

(iii) Intangibles

Intangibles must be capitalised if purchased either individually or as part of a sub acquisition.

Exploration licence

This was purchased, so must be capitalised.

Depreciation

Once the licence is in use then depreciation is applied. I would say in use means oil flowing. But no oil is flowing. So I suggest no depreciation yet.

Impairment

But it sounds like risky asset. So an impairment test is required.

Revaluation

But even if the impairment review reveals that the value has rocketed up, Burley cannot revalue. The IFRS on intangibles effectively prohibits revaluation (revaluation only if there is an active market for a homogenous intangible).

Answer 49 FI

This question was originally written as a vehicle to criticise old IAS39, but works well as a vehicle to praise IFRS9. That is the basis of this answer.

Marking guide
The usual 1 mark per point applies.

(a)(i)
Financial instruments
FI are carried either at fair value (fv) or amortised cost. But the classification of FI (financial instruments) is not quite so simple. Firstly, it breaks down into two components, the classification of FA (financial assets) and the classification of FL (financial liabilities).
Financial asset classification
FA are carried at fair value (FV), unless FA fulfil two tests, in which case they are carried at amortised cost. The two tests are the cash flow characteristics test and the business model test.

Financial asset classification in more detail
This is based upon asking two questions. Two yes and the asset is carried at amortised cost and one no and the asset is carried at fair value.

Cash flow characteristics test
This test is asking 'Does the debt asset have interest and principal repayment and no other features?'. In other words the IFRS is asking 'Do you have a simple loan?'

Business model test
This test is asking 'Is the debt asset managed for collection purposes?' In other words the IFRS is asking 'Do you intend to keep the asset until maturity?'

Comment
The above tsets are highly objective and work well for preparers. They also result in fair value unless an intent to hold to maturity can be shown which helps users. But I think it would be overplaying the subject to say that the rules are easy.

Two other FA issues
In fact the rules get even more complicated when you factor in two further issues:-
(1) Strategic equity
(2) FVO

Firstly, (1) Strategic equity:
Fair value accounting
The default position for the gains (and losses) on financial assets at fair value is the income statement.
FVTPL
These assets are often referred to as financial assets at fair value through profit or loss (FVTPL).
Strategic equity
However, if you have an equity investment and can show a strategic intent to keep the asset, then gains (and losses) can be pushed through other comprehensive income.
FVTOCI
This strategic equity is more commonly known as a financial asset at fair value through other comprehensive income (FVTOCI).

Now, (2) FVO:-

Mismatch

If an entity identifies an accounting mismatch then the entity may use the fair value option. An accounting mismatch occurs when there is a FA carried at amortised cost on the top of the position statement and a very similar FL carried at FV on the bottom of the position statement.

Fair value option (FVO)

When this occurs the entity can elect to carry the FA at fair value.

Financial liabilities classification

The story gets even more difficult when you look at fl classification. This is similar to fa classification, but different.

FL classification rule

FL classification is reasonably simple. All FL are carried at amortised cost unless an intent to trade the liability can be shown in which case fair value applies. An intent to trade an FL means an intent to go into the market and find someone to take the loan off you. It means taking a bag full of money into the market and trying to find someone who will take your money and the liability. This does happen, but it is incredibly rare. So almost without exception FL are carried at amortised cost.

Conclusion

There is no doubt that IFRS9 is much easier than old IAS39, but it is not easy.

(a)(ii)

Fair value

Fair value is defined as the transaction price between market participants at the measurement date.

Understood

This concept is widely understood by both preparers and users of fs. So increased application of fv would generally be less complex for preparers. And fv would certainly easier to understand for users.

Universal application

But the requirement asks about universal application. Clearly if absolutely all fi were carried at fv all of the time then this consistency would remove all the complexity and make fi very easy to understand.

Measurement

But measurement would be a problem. Currently most fi without a market are carried at amortised cost. Whilst this is not easy to calculate nor particularly meaningful for users at least the measurement is systematic.

Models

If these fi without a market were held fv then it may be necessary to estimate their fv using financial models like Black Scholes. This would be little more than guesswork and would introduce substantial uncertainty.

(b)

Future outflow

Both loans are obligations to pay \$60m on 30 November 2013. This may be shown as follows:-

First loan outflow	= \$47m(1.05^5)	= \$60m
Second loan outflow	= \$45m(1.074^4)	= \$60m

Market behaviour
The reason we got less cash from the issue of the more recent loan issue is because the interest rate has gone up and so more of the eventual $60m has to be earmarked for interest. That is how markets work.

Second loan
The second loan has only just been issued. So the fair value and amortised cost are the same. They are both $45m.

Amortised cost
If the first loan is carried at amortised cost then we will ignore the market. The liability is simply unwound:-

Year	opening	interest	instalment	closing
One	47	2.35	(0)	49.35

Fair value
But if the first loan is carried at fair value then we will recognise the market price. The market has told the company that $60m in four years is worth $45m. We can see this because that is what the market has given the company. So a fall in value of $2m (47-45) would go to p/l.

Question 50 Ashanti (Q1 June 2010)

The following financial statements relate to Ashanti, a public limited company.

Ashanti Group: Statements of comprehensive income for the year ended 30 April 2010.

	Ashanti	Bochem	Ceram
income for the year	$m	$m	$m
Revenue	810	235	142
Cost of sales	(686)	(137)	(84)
Gross profit	124	98	58
Other income	31	17	12
Distribution costs	(30)	(21)	(26)
Administrative expenses	(55)	(29)	(12)
Finance costs	(8)	(6)	(8)
Profit before tax	62	59	24
Income tax expense	(21)	(23)	(10)
Profit for the year	41	36	14
Other comprehensive income for the year, net of tax:			
Strategic equity gains	20	9	6
PPE revaluation gains (net)	12	6	–
Actuarial losses on defined benefit plan	(14)	–	–
Other comprehensive income for the year, net of tax	18	15	6
Total comprehensive income and expense for year	59	51	20

The following information is relevant to the preparation of the group statement of comprehensive income:

(1) On 1 May 2008, Ashanti acquired 70% of the equity interests of Bochem, a public limited company. The purchase consideration comprised cash of $150 million and the fair value of the identifiable net assets was $160 million at that date. The fair value of the non-controlling interest in Bochem was $54 million on 1 May 2008. Ashanti wishes to use the 'full goodwill' method for all acquisitions. The share capital and retained earnings of Bochem were $55 million and $85 million respectively and other components of equity were $10 million at the date of acquisition. The excess of the fair value of the identifiable net assets at acquisition is due to an increase in the value of plant, which is depreciated on the straight-line method and has a five year remaining life at the date of acquisition. Ashanti disposed of a 10% equity interest to the non-controlling interests (NCI) of Bochem on 30 April 2010 for a cash consideration of $34 million. The carrying value of the net assets of Bochem at 30 April 2010 was $210 million before any adjustments on consolidation. Goodwill has been impairment tested annually and as at 30 April 2009 had reduced in value by 15% and at 30 April 2010 had lost a further 5% of its original value before the sale of the equity interest to the NCI. The goodwill impairment should be allocated between group and NCI on the basis of equity shareholding.

(2) Bochem acquired 80% of the equity interests of Ceram, a public limited company, on 1 May 2008. The purchase consideration was cash of $136 million. Ceram's identifiable net assets were fair valued at $115 million and the NCI of Ceram attributable to Ashanti had a fair value of $26 million at that date. On 1 November 2009, Bochem disposed of 50% of the equity of Ceram for a consideration of $90 million. Ceram's identifiable net assets were $160 million and the fair value of the NCI of Ceram attributable to Bochem was $35 million at the date of disposal. The remaining equity interest of Ceram held by Bochem was fair valued at $45 million. After the disposal, Bochem can still exert significant influence. Goodwill had been impairment tested and no impairment had occurred. Ceram's profits are deemed to accrue evenly over the year.

(3) Ashanti has sold inventory to both Bochem and Ceram in October 2009. The sale price of the inventory was $10 million and $5 million respectively. Ashanti sells goods at a gross profit margin of 20% to group companies and third parties. At the year-end, half of the inventory sold to Bochem remained unsold but the entire inventory sold to Ceram had been sold to third parties.

(4) On 1 May 2009, Ashanti purchased a five-year bond with semi annual interest of 1% payable on 31 October and 30 April. The purchase price of the bond was $21·05 million. The effective annual interest rate is 8% or 4% on a semi annual basis. The bond is classified as carried at amortised cost. The issuer of the bond did not pay the interest due on 31 October 2009 and 30 April 2010. Ashanti feels that as at 30 April 2010, the bond is impaired and that the best estimates of total future cash receipts are $2·34 million on 30 April 2011 and $8 million on 30 April 2012. The current interest rate for discounting cash flows as at 30 April 2010 is 10%. No accounting entries have been made in the financial statements for the above bond since 30 April 2009. The group also has extensive holdings in financial assets at fair value through the other comprehensive income statement (FVTOCI). The financial assets are all equity investments with strategic intent to keep. So the gains have been labelled strategic equity gains.

(5) Ashanti sold $5 million of goods to a customer who recently made an announcement that it is restructuring its debts with its suppliers including Ashanti. It is probable that Ashanti will not recover the amounts outstanding. The goods were sold after the announcement was made although the order was placed prior to the announcement. Ashanti wishes to make an additional allowance of $8 million against the total receivable balance at the year end, of which $5 million relates to this sale.

(6) Ashanti owned a piece of property, plant and equipment (PPE) which cost $12 million and was purchased on May 2008. It is being depreciated over 10 years on the straight-line basis with zero residual value. On April 2009, it was revalued to $13 million and on 30 April 2010, the PPE was revalued to $8 million. The whole of the revaluation loss had been posted to the statement of comprehensive income and depreciation has been charged for the year. It is Ashanti's company policy to make all necessary transfers for excess depreciation following revaluation.

(7) The salaried employees of Ashanti are entitled to 25 days paid leave each year. The entitlement accrues evenly over the year and unused leave may be carried forward for one year. The holiday year is the same as the financial year. At 30 April 2010, Ashanti has 900 salaried employees and the average unused holiday entitlement is three days per employee. 5% of employees leave without taking their entitlement and there is no cash payment when an employee leaves in respect of holiday entitlement. There are 255 working days in the year and the total annual salary cost is $19 million. No adjustment has been made in the financial statements for the above and there was no opening accrual required for holiday entitlement.

(8) Ignore any taxation effects of the above adjustments and the disclosure requirements of IFRS 5 Non-current assets held for sale and discontinued operations.

Required:

(a) Prepare a consolidated statement of comprehensive income for the year ended 30 April 2010 for the Ashanti Group.

(35 marks)

The directors of Ashanti have heard that the International Accounting Standards Board (IASB) has issued amendments to the rules regarding reclassification of financial instruments. The directors believe that the IASB has issued these amendments to reduce the difference between US GAAP and IFRS in respect of reclassification of financial assets. Reclassification, which was previously severely restricted under the IFRS, is now permitted in specific circumstances if the conditions and disclosure requirements are followed. They feel that this will give them the capability of managing their earnings, as they will be able to reclassify loss-making financial assets and smooth income. They feel that there is no problem with managing earnings as long as the shareholders do not find out and as long as the accounting practices are within the guidelines set out in International Financial Reporting Standards (IFRS).

Required:

(b) Describe the rules regarding reclassification of financial assets under IFRS9 Financial Instruments, discussing whether these rules could lead to 'management of earnings'.

(7 marks)

(c) Discuss the nature of and incentives for 'management of earnings' and whether such a process can be deemed to be ethically acceptable.

(6 marks)

Professional marks will be awarded in question 1(c) for clarity and quality of discussion.

(2 marks)

(50 marks)

Question 51 Cate (Q2 June 2010)

Cate is an entity in the software industry.

(a) Cate had incurred substantial losses in the financial years 31 May 2004 to 31 May 2009. In the financial year to 31 May 2010 Cate made a small profit before tax. This included significant non-operating gains. In 2009, Cate recognised a material deferred tax asset in respect of carried forward losses, which will expire during 2012. Cate again recognised the deferred tax asset in 2010 on the basis of anticipated performance in the years from 2010 to 2012, based on budgets prepared in 2010. The budgets included high growth rates in profitability. Cate argued that the budgets were realistic as there were positive indications from customers about future orders. Cate also had plans to expand sales to new markets and to sell new products whose development would be completed soon. Cate was taking measures to increase sales, implementing new programs to improve both productivity and profitability. Deferred tax assets less deferred tax liabilities represent 25% of shareholders' equity at 31 May 2010. There are no tax planning opportunities available to Cate that would create taxable profit in the near future.

(5 marks)

(b) At 31 May 2010 Cate held an investment in and had a significant influence over Bates, a public limited company. Cate had carried out an impairment test in respect of its investment in accordance with the procedures prescribed in IAS 36, *Impairment of assets.* Cate argued that fair value was the only measure applicable in this case as value-in-use was not determinable as cash flow estimates had not been produced. Cate stated that there were no plans to dispose of the shareholding and hence there was no binding sale agreement. Cate also stated that the quoted share price was not an appropriate measure when considering the fair value of Cate's significant influence on Bates. Therefore, Cate estimated the fair value of its interest in Bates through application of two measurement techniques; one based on earnings multiples and the other based on an option–pricing model. Neither of these methods supported the existence of an impairment loss as of 31 May 2010.

(5 marks)

(c) On 1 April 2009 Cate bought a direct holding of shares giving 70% of the equity voting rights in Date. In May 2010, Date issued new shares, which were wholly subscribed for by a new investor. After the increase in capital, Cate retained an interest of 35% of the voting rights in its former subsidiary Date. At the same time, the shareholders of Date signed an agreement providing new governance rules for Date. Based on this new agreement, Cate was no longer to be represented on Date's board or participate in its management. As a consequence Cate considered that its decision not to subscribe to the issue of new shares was equivalent to a decision to disinvest in Date. Cate argued that the decision not to invest clearly showed its new intention not to recover the investment in Date principally through continuing use of the asset and was considering selling the investment. Due to the fact that Date is a separate line of business (with separate cash flows, management and customers), Cate considered that the results of Date for the period to 31 May 2010 should be presented based on principles provided by IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

(8 marks)

(d) In its 2010 financial statements, Cate disclosed the existence of a voluntary fund established in order to provide a post-retirement benefit plan (Plan) to employees. Cate considers its contributions to the Plan to be voluntary, and has not recorded any related liability in its consolidated financial statements. Cate has a history of paying benefits to its former employees, even increasing them to keep pace with inflation since the commencement of the Plan. The main characteristics of the Plan are as follows:

the Plan is totally funded by Cate;

the contributions for the Plan are made periodically;

the post retirement benefit is calculated based on a percentage of the final salaries of Plan participants dependent on the years of service;

the annual contributions to the Plan are determined as a function of the fair value of the assets less the liability arising from past services.

Cate argues that it should not have to recognise the Plan because, according to the underlying contract, it can terminate its contributions to the Plan, if and when it wishes. The termination clauses of the contract establish that Cate must immediately purchase lifetime annuities from an insurance company for all the retired employees who are already receiving benefit when the termination of the contribution is communicated.

(5 marks)

Required:

Discuss whether the accounting treatments proposed by the company are acceptable under International Financial Reporting Standards.

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

(2 marks)

The mark allocation is shown against each of the four parts above.

(25 marks)

Question 52 Seltec (Q3 June 2010)

Seltec, a public limited company, processes and sells edible oils and uses several financial instruments to spread the risk of fluctuation in the price of the edible oils. The entity operates in an environment where the transactions are normally denominated in dollars. The functional currency of Seltec is the dollar.

(a) The entity uses forward and futures contracts to protect it against fluctuation in the price of edible oils. Where forwards are used the company often takes delivery of the edible oil and sells it shortly afterwards. The contracts are constructed with future delivery in mind but the contracts also allow net settlement in cash as an alternative. The net settlement is based on the change in the price of the oil since the start of the contract. Seltec uses the proceeds of a net settlement to purchase a different type of oil or purchase from a different supplier. Where futures are used these sometimes relate to edible oils of a different type and market than those of Seltec's own inventory of edible oil. The company intends to apply hedge accounting to these contracts in order to protect itself from earnings volatility. Seltec has also entered into a long-term arrangement to buy oil from a foreign entity whose currency is the dinar. The commitment stipulates that the fixed purchase price will be denominated in pounds sterling.

Seltec is unsure as to the nature of derivatives and hedge accounting techniques and has asked your advice on how the above financial instruments should be dealt with in the financial statements.

(14 marks)

(b) Seltec has decided to enter the retail market and has recently purchased two well-known brand names in the edible oil industry. One of the brand names has been in existence for many years and has a good reputation for quality. The other brand name is named after a famous fi lm star who has been actively promoting the edible oil as being a healthier option than other brands of oil. This type of oil has only been on the market for a short time. Seltec is finding it difficult to estimate the useful life of the brands and therefore intends to treat the brands as having indefinite lives.

In order to sell the oil, Seltec has purchased two limited liability companies from a company that owns several retail outlets. Each entity owns retail outlets in several shopping complexes. The only assets of each entity are the retail outlets. There is no operational activity and at present the entities have no employees.

Seltec is unclear as to how the purchase of the brands and the entities should be accounted for.

(9 marks)

Required:

Discuss the accounting principles involved in accounting for the above transactions and how the above transactions should be treated in the financial statements of Seltec.

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

(2 marks)

The mark allocation is shown against each of the two parts above.

(25 arks)

Question 53 Holcombe (Q4 June 2010)

(a) Leasing is important to Holcombe, a public limited company as a method of financing the business. The Directors feel that it is important that they provide users of financial statements with a complete and understandable picture of the entity's leasing activities. They believe that the current accounting model is inadequate and does not meet the needs of users of financial statements.

Holcombe has leased plant for a fixed term of six years and the useful life of the plant is 12 years. The lease is non-cancellable, and there are no rights to extend the lease term or purchase the machine at the end of the term. There are no guarantees of its value at that point. The lessor does not have the right of access to the plant until the end of the contract or unless permission is granted by Holcombe.

Fixed lease payments are due annually over the lease term after delivery of the plant, which is maintained by Holcombe. Holcombe accounts for the lease as an operating lease but the directors are unsure as to whether the accounting treatment of an operating lease is conceptually correct.

Required:

(i) **Discuss the reasons why the current lease accounting standards may fail to meet the needs of users and could be said to be conceptually flawed;**

(7 marks)

(ii) **Discuss whether the plant operating lease in the financial statements of Holcombe meets the definition of an asset and liability as set out in the 'Framework for the Preparation and Presentation of Financial Statements.'**

(7 marks)

Professional marks will be awarded in part (a) (i) and (ii) for clarity and quality of discussion.

(2 marks)

(b) Holcombe also owns an office building with a remaining useful life of 30 years. The carrying amount of the building is $120 million and its fair value is $150 million. On 1 May 2009, Holcombe sells the building to Brook, a public limited company, for its fair value and leases it back for five years at an annual rental payable in arrears of $16 million on the last day of the financial year (30 April). This is a fair market rental. Holcombe's incremental borrowing rate is 8%.

On 1 May 2009, Holcombe has also entered into a short operating lease agreement to lease another building. The lease will last for three years and is currently $5 million per annum. However an inflation adjustment will be made at the conclusion of leasing years 1 and 2. Currently inflation is 4% per annum.

The following discount factors are relevant (8%).

	Single cash flow	Annuity
Year 1	0·926	0·926
Year 2	0·857	1·783
Year 3	0·794	2·577
Year 4	0·735	3·312
Year 5	0·681	3·993

Required:

(i) **Show the accounting entries in the year of the sale and lease back assuming that the operating lease is recognised as an asset in the statement of financial position of Holcombe;**

(6 marks)

(ii) **State how the inflation adjustment on the short term operating lease should be dealt with in the financial statements of Holcombe.**

(3 marks)

(25 marks)

Answer 50 Ashanti

(a)

Group Structure
This is not required and carries no marks but it is often helpful when groups get complex.

A
↓ 70%
B (then a year end transfer of 10%)
↓ 80%
C (then a mid year loss of control)

(0 marks)

Year Start NCI
Very unusually the year start nci was given a mark.

	CI	NCI
B	70%	30%
C (70% of 80%)	56%	44%

(1 mark)

Net Assets
The net assets working was awkward. The data was presented in an odd way. For example, the book value of na in Bochem at acquisition was calculated as $150m but at transfer the same book value was simply given as $210m.

	BOCHEM		CERAM	
	Acquisition	Transfer	Acquisition	Disposal
Share capital	55			
Retained earnings	85			
Other equity	10			
Book value	150	210 given		
FVA (160-150)	10	10		
FVA Depn (2/5) (10)		(4)		
Fair Value (PARA 1)	160given	216		
Na given (PARA 2)			115	160

(2 marks)

Note that current year FVA depreciation was $2m [Depn = 1/5(10)= 2]. This is charged to cost of sales.

Goodwill

	%	Working	B	%	Working	C
FV of consideration	70%		150	56%	(70%)(136)	95.2
FV of NCI	30%		54	44%		26.0
FV of NA			(160)			(115)
Goodwill @ acquisition			44			6.2
Impairment (15%)(44) [last year]			(6.6)			=
Goodwill current opening			37.4			6.2
Impairment (5%)(44) [this year]			(2.2)			=
Goodwill current closing			35.2			6.2

(6 marks)

Transfer: Year end transfer of Bochem ownership
Transfer from CI to NCI. So use percentage of whole sub.

Sub carrying value (NA 216 + GW 35.2)	251.2
Percentage transferred	10%
Transfer	25.12
Transfer out	(25.12)
Consideration in (PARA (1))	34
Increase to OCE (reported in SOCIE)	8.88

(2 marks)

Disposal: Mid year disposal of Ceram Sub
Disposal from mid Sub perspective

Actual sale proceeds	90
Deemed sale proceeds	45
NCI	35
NA	(160)
GW	(62)
Profit	3.8

(3 marks)

The above makes less than perfect sense because it includes the NCI from the mid sub perspective ($35m) and the Goodwill from the Parent perspective ($6.2m) but, it is probably the best you can do given the information available. The IFRS give little guidance here but, calculating the disposal from the Parent viewpoint may be more logical

Group Comprehensive Income Statement

	A Parent	B Sub	C Sub	Adjustment	Group
Income Statement	(12/12)	(12/12)	(6/12)		
Revenue	810 (5) PARA5	235	71	(15) Para3	1096
Cost of Sales	(686) (1) PARA3 (1.6) PARA6	(137) FVA (2) GW (2.2)	(42)	(15) Para3	(857)
Gross Profit					239
Other income	31	17	6		54
Distribution	(30) (3) PARA5	(21)	(13)		(67)
Administration	(55) (0.21) PARA7	(29)	(6)		(90)
Operating Profit					136
Associate		2.1			2
Disposal		3.8			4
Finance Cost	(8)	(6)	(4)		(18)
Finance Income	1.67 PARA4				2
Financial Impairment	(13.38) PARA4				(13)
PBT					113
TAX	(21)	(23)	(5)		(49)
PAT	17.88	37.7 X 30%	7 X44%		64
NCI		11.31	3.08		(14)
PAM					50
Other Comprehensive Income					
Strategic equity gains	20	9	3		32
Associate strategic equity gains		0.9			1
PPE Revaluation gains	12 1.6 PARA6	6			20
Pension	(14)	-	-		(14)
OCI		15.9 X 30%	3 X44%		39
NCI		4.77	1.32		(6)
OCIAM					33

Further marks for CIS itself including the format, time apportionment and transferring of numbers from workings.

(5 marks)

PAM=Profit attributable to members
OCIAM=Other comprehensive income attributable to members

Paragraph 3 PUP

Inter company sales	10 + 5	= $15m
Parent PUP	(20%)(10)(1/2)	= $1m

(2 marks)

Paragraph 4 Bond impairment

Closing carrying value before impairment [20.45(1.04)^2]	22.12
Current impairment (Balance)	13.38
Recoverable value [2.34(1/1.1) + 8(1/1.1^2)]	8.74

(4 marks)

Note that the above abbreviated answer is plenty enough to score all four marks. However, the following may help to understand how the above short cut works.

Carrying Value
We roll forward the opening CV to the closing CV by accruing 2 six month interest accruals. This is recognised in Finance Income. Note that there are no instalments flowing in because the borrower does not pay. So the asset grows in expectation of capital and interest.

Opening	Interest	Instalment	Closing
(given) 20.45	0.82	-	21.27
21.27	0.85	-	22.12

The combined interest for the year is $1.67m and goes into finance income. Note that this question indicates that the impairment is at the year end. So we accrue the interest for the year even though there is no cash flowing in from the borrower. Perhaps it would make more sense to recognise the impairment at the year start. Perhaps the impairment really happens immediately after purchase. But that is not how the question is written. The question tells us the impairment is at the year end. The impairment is down to the recoverable value, calculated by discounted cash flow.

Recoverable Value – We discount the projected cash flow

Year	CF	DF (10%)	PV
1	2.34	0.909	2.13
2	8.00	0.826	6.61
PV			8.74

Impairment
The impairment is so huge I have recognised the cost as a separate item on the i/s. This or other methods of disclosure are equally acceptable.

Current rate
Note how the current rate of 10% is ignored throughout. This is because the standard views market information as irrelevant for fi at amortised cost because the investor has turned their back on the market and is awaiting returns only from the borrower.

Conclusion
In conclusion, the accounting entries required to address paragraph (4) are the recognition of finance income of $1.65m and the recognition of a financial impairment of $13.38m.

PARA 5 Bad Debts (and non-sale)

A sale must be considered recoverable at the point of sale. The $5m transfer was to customer after announcement so was a non-sale, and not a bad debt (IAS18).

	$m	
Non Sale	5	(against revenue)
Genuine Bad Debt (Balance)	3	(against distribution)
Given	8	

(2 marks)

PARA 6 Impairment (and reversal) of PPE

	$m	
Cost	12.00	
Depn (12/10 yrs)	(1.20)	
Before revaluation	10.80	
Revaluation gain	2.20	
After revaluation (Given)	13.00	
Depn (13/9 yrs)	1.44	
Before fall in value	11.56	
Reversal (balance) {or (2.2)(8/9) see below}	(1.96)	to OCI
Historical NBV ($12m)(8/10)	9.60	
Impairment (Balance)	(1.60)	to i/s
After fall in value (Given)	8.00	

(4 marks)

Reversal of previous revaluation is limited by the historical NBV. The historical NBV is the CV one would have if nothing but depreciation had occurred. The reversal is also limited to remaining revaluation reserve after one year realisation transfer. This slightly different way of looking at reversal gives the exact same answer.

	Revaluation Reserve $m
Opening	2.2
Transfer to RE (2.2/9years)	0.24
Closing	1.96
Reversal of whole reserve to OCI	(1.96)
Remaining	0.00

Moving the impairment

The question tells us that currently the whole $3.56m fall in value is in the OCI. Currently the whole fall of $3.56 in the current year is classified as a reversal in the OCI. When the $1.60m impairment is moved into I/S it will reduce the reversal and so increase the net revaluation gain in the OCI by $1.6m. To repeat, when the impairment loss is moved out of the OCI the effect is make the net revaluation gains bigger.

Paragraph 7 Provision for Employee Liability

The employees have done slightly more than a years work in one year and so there is a liability and a cost.JJ

Provision = (95%) (3/255) $19m
= $0.21m (against administration)

(2 marks)

Associate

The associate can be interpreted as being the 30% associate of BOCHEM resulting in the following:

Associate (I/S) (30%)(6/12)(14)	= 2.1
Associate (OCI) (30%)(6/12)(6)	= 0.9

The above looks right, but has the odd effect of resulting in NCI in an entity over which we don't have control. So the alternative is to interpret the associate as associated to the whole group resulting in the following:-

Associate (I/S) (70%)(30%)(6/12)(14)	= 1.47
Associate (OCI (70%)(30%)(6/12)(6)	= 0.63

Either is acceptable.

(2 marks)

Marking Guide

	Mark
Year Start NCI	1
FVA in NA working	2
Goodwill BOCHEM	3
Goodwill CERAM	3
Transfer	2
Disposal	3
Comprehensive Income Statement	5
PARA 3 (PUP Sales)	2
PARA 4 (AFS impairment)	4
PARA 5 (Bad Debts)	2
PARA 6 (PPE impairment)	4
PARA 7 (Employee liability)	2
Associate	2
Marks	35

Obviously, no students will get anywhere near perfection in one hour but, many students did get over 30 marks and huge numbers got over 20 marks. There are three things to bear in mind:-

1. Marking Guide

Markers are encouraged to use the above only as a guide and award marks generously

2. Wrong Answers

Wrong answers get lots of marks, say we are talking about PARA (6) worth 4 marks, then this is how the marks are awarded.

Close	4/4 marks
Not bad	3/4 marks
Had a go	2/4 marks

3. Groups Marks

Besides groups is only 35 marks, you pass P2 in the other 65 marks.

(b) Marking guide

The usual marking guide of 1 mark per valid point applies. In common with many question (1)(b), this question (1)(b) looks painfully technical but really is not. All you have to do is read the little scenario above the requirement and comment on it in accordance with the requirement.

Classification

Keeping it simple, there are essentially two classes of financial asset; those carried at fair value and those carried at amortised cost. An asset is carried at amortised cost if it fulfils two tests. An asset is carried at fair value if not.

Two tests

The two tests are the cash flow characteristics test and the business model test.

Previously

As the scenario says, previously the reclassification from one to the other was restricted. So once an asset was carried at fair value then this would continue.

Currently

As the scenario says, these reclassification restrictions have been lifted and an asset can start in one class and then move to the other.

Disclosure

As the scenario says, this is permitted provided the circumstances are disclosed.

Circumstances

But the only circumstances under which a reclassification can occur is if the nature of the asset changes. If an asset at amortised cost ceased to fulfil both test then in would be classified at fair value. A similar idea applies in the opposite direction.

Convergence

As the scenario says, this was to reduce the differences between IFRS and US GAAP. As you might imagine, this reclassification clause was introduced by the IASB in order to smooth the process of convergence.

Level playing field

There is also an element of level playing field. After all, if US banks can reclassify, why not EU banks.

Creative accounting

As the scenario says, this does create the opportunity for profit manipulation. It does not take a genius to see that classification under fair value during the good years and reclassification to amortised cost in the bad years will allow gains to show but allow losses to be hidden.

Profit smoothing

This simple scam is often called profit smoothing as it hides the troughs in fair value when market falls. It can even be used to hide the peaks in fair value when the market rises.

Manipulation

But it would probably quite a bit of work to prove to an auditor that the circumstances had changed and that reclassification was necessary. But manipulation would be possible.

(c) Marking guide

1 mark per point.

Management of earnings

The above is just a cute way of saying creative accounting. Frankly creative accounting is just a cute way of saying lying.

Creative accounting

But creative accounting or management of earnings is more than just lying. It is manipulating the information to paint the picture that you want rather than the picture as it really is.

Manipulation

Manipulation is such a lovely word in this context as it implies that the accountant is skating on the thin ice between out and out bare face lies and genuine reporting.

Example (1) reclassification

The above is such a good example, because flip flopping from fv to cost on fi is just about permissible but clearly not in tune with the true and fair view.

Example (2) pensions

You could argue that using the corridor method to treat pension losses as assets is similar. It is permitted by the rules but is not in tune with the true and fair view.

Incentives

Directors are incentivised to use creative accounting firstly and most obviously by profit related pay.

Share based payment

But more subtly, directors are also motivated to manipulate the fs to persuade shareholders that the company is better than it is in order to push up share price and thereby the value of directors' options.

Ethics

Like all ethics, the ethics here are blurred. But I would suggest that the primary duty of the directors when communicating with their fs users is to tell a true and fair view. This management of earnings is clearly not in tune with the true and fair view.

Nanny accounting

There is another slightly different way of looking at this. For years directors took it as being part of their responsibility to cover up the bad things that happen in business life by nanny accounting. Profit smoothing is a classic example.

New culture

Now commentators are encouraging directors to tell it like it is. The new philosophy is that if stuff goes up and down in value then directors should tell shareholders this. But like any culture change; it takes time to settle down.

Answer 51 Cate

This was an absolute classic industry or mix question, but oddly was positioned as question2, rather than the usual position of question 3.

(a)

Deferred tax

Deferred tax (DT) is based on the following:-

DT = TD x %

Where TD is temporary difference and % is corporation tax rate.

Temporary difference

This has its own equation:-

TD = CV – TB

Where CV is the financial accounting carrying value and TB is the tax accounting tax base.

Losses

We financial accountants lose losses in equity. But the tax accountants carry them forward as assets. So losses give rise to DT as illustrated by the following assuming a loss of $100m:-

	CV		TB	TD
Loss	0	-	100	= (100)
				X30%
DT asset				(30)

Negative TD

By the way, the fancy name for a negative TD is a deductable TD. As you can see from the above, a negative TD always gives rise to a DT asset.

Asset

But an asset is only recognised as an asset if it is a present right to a future economic inflow. In the context of tax losses carried forward, that means tax losses are only useful if they can be set off against future profits.

Cate

But Cate does not look likely to return to underlying profits soon because Cate only made a profit this year as a result of non-operating gains. Further although Cate is trying to make it look like the future is bright it is not very convincing.

Conclusion

I suggest the DT asset is not recoverable and should not be recognised.

(b)

Impairment

This occurs when the recoverable value of an asset falls below the carrying value (IAS36).

Recoverable value

This is the higher of:

VIU = value in use

NRV = net realisable value (sometimes known as fair value less costs to sell)

Impairment test

To do the test properly, Cate should have both figures. If Cate really does have significant influence, then Cate should have no problems getting VIU information from Bates.

Fair value

Besides deliberately ignoring the obvious fair value available in the form of the market value looks very suspicious.

Conclusion

This looks like creative accounting. It looks like Cate is trying to avoid impairment. Cate should use the market value and get on with the impairment test.

(c)

Control

IFRS make it very clear that a sub is defined by control. Sub acquisition occurs when we get control and sub disposal occurs when we lose control (IAS27).

Disposal

So when Cate tells Date to issue shares to a new investor and the Cate ownership and voting falls to 35% then Cate loses control and the result is a sub disposal.

Discontinued

The scenario tells us that Date is in a separate line of business. Obviously we stopped doing that separate line of business towards the end of the year. So the operation is discontinued (IFRS5).

Income statement

The effect in the income statement is similar but different to that in question 1 Ashanti. Question 1 makes no mention of a different line of business. So the Ceram disposal is not a discontinuance. So Ashanti time apportioned Ceram then simply consolidated Ceram. But Cate time apportions Date and then puts the PAT into Discontinued at the bottom of the income statement and only discloses the details in the notes.

Profit on disposal

IFRS also make it clear that when we lose control we are deemed to have sold the whole sub and bought back another investment (IFRS3). The result is the following:-

Actual sale proceeds	x
Deemed sale proceeds	x
NCI	x
NA	(x)
GW	(x)
Profit	x

Remaining investment

The story tells us that Cate have lost their place on the board. So it is possible Cate retain no influence. If this is true then the remaining asset is a simple investment at fair value with gains to income statement.

Associate

On the other hand it is possible that Cate still retains the power to influence Date, just chooses not to get involved. If this is true then Date is an associate after the share issue.

Held for sale

The associate will be considered held for sale if it fulfils these criteria:

S Sell	= there must be an intent to sell
A Available	= the associate must be available for immediate sale
L Locate	= directors must be marketing to locate a buyer
E Expected	= the sale must be expected within 12 months

Considering

But Cate is only considering the sale. There is no clear intent at the year end. So I suggest the associate stays in non current assets.

(d)

Pensions

There are two types and there meanings are literal:

Defined contribution plan

Defined benefit plan

Final salary

Para (iii) makes it clear that it is the benefit that is defined. So this is a defined benefit plan.

Position statement

This is the really complicated pension with a growing asset, separate growing liability and an actuary to manage the two. The IFRS requires detailed disclosure in the notes and a net liability on the face of the balance sheet (IAS 19).

Performance statement

Into the income statement go the service cost, the unwinding cost and the expected return. Into the OCI goes the actuarial gain.

Complication

There is one notable complication. The pension is described as voluntary and that is why Cate is claiming to have no liability. However, I think the mention of an underlying contract gives away that the pension is not voluntary and so defined benefit pension accounting is required.

Answer 52 Seltec

This was a double header focus question of the type seen before in p2. Past focus questions Norman and Macaljoy were both double headers. So instead of focussing on just one subject, Seltec had two; financial instruments and intangibles. Unusually, this focus question has been positioned as question 3.

Marking guide

1 mark per reasonable point.

(a) Note that the following answer would easily score 14. Far worse answers were given 14 in marking standardisation.

Summary

This story relates to three separate derivative financial instruments; the forwards, the futures and the long term arrangement. This answer will deal with them in order.

Financial instrument

A financial instrument is a contract that creates a relationship. So a financial asset in one entity will create a financial liability in another.

Derivative

A derivative financial asset is one that derives its value from something else. They usually cost next to nothing and are effectively bets on that something else.

Forwards

These are contracts that are orders to take delivery of an asset at a certain fixed price. They are negotiated directly with the supplier and are different each time.

Seltec forwards

Seltec use these to order their edible oils. They almost always take delivery of the oils when the contract comes to an end. So I suggest they are just treated like orders for goods and therefore do not appear in the fs.

Alternative

But like most things in financial reporting, there is an alternative way to look at the forwards. It could be argued that they are hedge bets addressing a fear that edible oil prices might go up. If this is the view taken by Seltec then the forwards should be treated the same as the futures below.

Futures

These are similar to forwards in that they are orders to take delivery of an asset at a certain fixed price. But they are written in a consistent way so that they can be bought and sold on a derivative market. The result is they are almost always settled in cash and not by delivery.

Derivatives

So futures definitely are bets. Seltec cannot claim that these are simply orders for edible oil. But there are two different reasons to bet; one reason is to speculate and the other is to hedge.

Hedging

Hedging is the process of betting on whatever you fear. It looks like Seltec fear rises in edible oil prices and then bet on that using futures. The result is that if prices do rise then they will pay more for their oil but have a mitigating win on their bet.

Cash flow hedging

To me this looks like cash flow hedging. Cash flow hedging occurs when you bet on the price of an asset rising before you can get hold of the asset. In this case Seltec is betting on a rise in edible oils before the oil comes to the market.

Cash flow hedge accounting

This requires that the gains and losses on the hedge derivative are carried in a hedge reserve until the deal closes out. I would suggest Seltec use this technique for their futures.

Long term arrangement

This element of the story refers to a very difficult and contentious part of financial instrument accounting. It is called embedded derivatives.

Sterling

Because Seltec has contracted for oils in Sterling, it has accidentally ended up betting on Sterling. The IAS argues that this arrangement is mostly a simple deal to get delivery of edible oils. But the IAS argues that a little bit of the deal is an accidental bet on Sterling.

Embedded derivative

This accidental bet on Sterling is called an embedded derivative and must be stripped out of the basic deal and accounted for separately. It is an absolute nightmare in real life and the IASB propose to abandon the idea.

(b)

Intangibles

Brands are intangibles and intangibles are only recognised if they are purchased (either individually or as part of a sub acquisition).

Both brands

Both brands have been purchased individually. So both brands must be separately recognised on the position statement. So far Seltec has the accounting right.

Depreciation

It is a basic rule of non current asset accounting that both tangibles and intangibles are depreciated over their lives.

Difficult

The reference to the estimation of asset life being difficult is just nonsense. Just because it is difficult to estimate a machine life does not mean you do not depreciate it. If everybody gave up so easily then nothing would ever be depreciated.

Infinite life

On the other hand an infinite life is possible. It happens with land and it can happen with well established well supported brands.

Old brand

I suggest the old brand does match up to the criteria for an infinite life. So making an annual impairment review with no depreciation is reasonable.

New brand

The film star brand is new and likely to wane with the popularity of the film star. So a life should be estimated and used for depreciation.

Two companies

This is quite tricky. The two companies look like subs because they are incorporated. But actually they are not doing anything.

Sub

For a sub to be a sub and an acquisition to be an acquisition the target must be doing something. The target must be an operation or a business. As IFRS3 calls it in the title of IFRS3, the deal must be a "Business Combination".

Business

But neither company is doing anything. Neither is a business. So neither purchase is a business combination.

Conclusion

So the cost of the two companies is just the initial cost of two leases and simple lease accounting is used.

Goodwill

For the sake of clarity, this of course means there is no goodwill. You cannot have goodwill without a business combination.

Answer 53 Holcombe

Marking guide

1 mark per valid idea clearly explained, as usual.

(a)(i)

Current lease accounting

This is based upon distinguishing between two types of lease using risks and rewards (IAS17):

Risks and rewards	*lease accounting*
With lessee	finance lease
With lessor	operating lease

More strictly, any lease where the risks and rewards have not been substantially transferred to the lessee is an operating lease. You see this in part (a)(ii).

Finance lease

As the name suggests, this requires the lessee to recognise an asset and corresponding finance.

Operating lease

However, this requires the lessee to recognise only rent as an operating cost.

Distinction

But the distinction above is tricky in practice because almost always there are some risks and rewards on both sides.

Creative accounting

This leads to creative accounting. Accountants who want to push finance off the balance sheet can easily do so by making a finance lease look like an operating lease.

Obligation

Besides even a true operating lease involves a contract and this involves an obligation to make payments. Surely this is a liability.

Rights

Also even a true operating lease gives rights to use ppe. Surely this is an asset.

Conceptual flaw

So current lease accounting recognises operating leases and the resultant accounting ignores clear assets and liabilities.

Users

Users a failed by this because they don't get to see all the assets and liabilities of an entity.

(a)(ii)

Holcombe lease

Holcombe has leased 6 out of 12 years. It is clear that far less than all risks and rewards have been transferred to Holcombe.

Conclusion

So under current financial reporting this is an operating lease. A simple rent charge will go into cost of sales.

Conceptual correctness

As pointed out both by the directors and by me in part (a)(i) above, this is conceptually incorrect. But it should be noted that for the purpose of Holcombe fs this is irrelevant. The rules are clear for this Holcombe lease and operating lease accounting is required.

Asset

To paraphrase the framework, an asset is a present right to a future economic inflow.

Holcombe asset

Holcombe has the right to use the machine for 6 years. Fairly obviously this does meet the above definition.

Liability

To paraphrase the framework, a liability is the present obligation to a future economic outflow.

Holcombe liability

Holcombe has signed up to 6 years of cash outflow. Fairly obviously this fulfils the definition of a liability.

IASB

This is why the IASB are proposing to abandon operating lease accounting in favour of finance lease accounting.

(b)(i)

This was a tricky requirement to interpret. It was asking us to do the double entry for the lease assuming that we recognise the right to 5 years access of the building as an asset. There are lots of ways to answer this question, all of which would be marked right. Here is my personal favourite; it is based on simply selling one asset and then buying a new one on finance. The numbers and double entry are all identical to normal finance lease accounting.

Sale

Dr	bank	150
Cr	building	120
Cr	disposal profit	30

Purchase

Dr	asset ($16m)(3.993)	63.89
Cr	liability	63.89

Depreciation

Dr	depreciation (63.89/5years)	12.78
Cr	asset	12.78

Interest accrual

Dr	interest (63.89)8%	5.11
Cr	liability	5.11

Instalment

Dr	liability	16
Cr	bank	16

(b)(ii)

Liability

Again to paraphrase the framework, a liability is a present obligation to a future outflow.

Present

At present Holcombe simply owe three times $5m. So inflation is ignored.

Next year

If the liability changes next year, then we can change it next year.

Question 54 Jocatt (Q1 December 2010)

The following draft group financial statements relate to Jocatt, a public limited company:

Jocatt Group: Statement of financial position as at 30 November

	2010	2009
	$m	$m
Assets		
Non-current assets		
Property, plant and equipment	327	254
Investment property	8	6
Goodwill	48	68
Intangible assets	85	72
Investment in associate	54	–
financial assets	94	90
	616	490
Current assets		
Inventories	105	128
Trade receivables	62	113
Cash and cash equivalents	232	143
	399	384
Total assets	1,015	874
Equity and Liabilities		
Equity attributable to the owners of the parent:		
Share capital	290	275
Retained earnings	351	324
Other components of equity	15	20
	656	619
Non-controlling interest	55	36
Total equity	711	655
Non-current liabilities:		
Long-term borrowings	67	71
Deferred tax	35	41
Long-term provisions-pension liability	25	22
Total non-current liabilities	127	134
Current liabilities:		
Trade payables	144	55
Current tax payable	33	30
Total current liabilities	177	85
Total liabilities	304	219
Total equity and liabilities	1,015	874

Jocatt Group: Statement of comprehensive income for the year ended 30 November 2010

	$m
Revenue	432
Cost of sales	(317)
Gross profit	115
Other income	25
Distribution costs	(55·5)
Administrative expenses	(36)
Finance costs paid	(6)
Gains on property	10·5
Share of profit of associate	6
Profit before tax	59
Income tax expense	(11)
Profit for the year	48
Other comprehensive income after tax:	
Gain on financial assets	2
Losses on property revaluation	(7)
Actuarial losses on defined benefit plan	(6)
Other comprehensive income for the year, net of tax	(11)
Total comprehensive income for the year	37
Profit attributable to:	
Owners of the parent	38
Non-controlling interest	10
	48

Total comprehensive income attributable to:

	$m
Owners of the parent	27
Non-controlling interest	10
	37

Jocatt Group: Statement of changes in equity for the year ended 30 November 2010

	Share Capital	Retained Earnings	Gains on financial assets	Revaluation Surplus (PPE)	Total	Non-controlling Interest	Total equity
	$m	$m	$m	$m	$m	$m	$m
Balance at 1 December 2009	275	324	4	16	619	36	655
Share capital issued	15				15		15
Dividends		(5)			(5)	(13)	(18)
Rights issue						2	2
Acquisitions						20	20
Total comprehensive income for the year		32	2	(7)	27	10	37
Balance at 30 November 2010	290	351	6	9	656	55	711

The following information relates to the financial statements of Jocatt:

(i) On 1 December 2008, Jocatt acquired 8% of the ordinary shares of Tigret. Jocatt had treated this investment as fair value through other comprehensive income (FVTOCI) in the financial statements to 30 November 2009. On 1 December 2009, Jocatt acquired a further 52% of the ordinary shares of Tigret and gained control of the company. The consideration for the acquisitions was as follows:

	Holding	Consideration $m
1 December 2008	8%	4
1 December 2009	52%	30
	60%	34

At 1 December 2009, the fair value of the 8% holding in Tigret held by Jocatt at the time of the business combination was $5 million and the fair value of the non-controlling interest in Tigret was $20 million. No gain or loss on the 8% holding in Tigret had been reported in the financial statements at 1 December 2009. The purchase consideration at 1 December 2009 comprised cash of $15 million and shares of $15 million.

The fair value of the identifiable net assets of Tigret, excluding deferred tax assets and liabilities, at the date of acquisition comprised the following:

	$m
Property, plant and equipment	15
Intangible assets	18
Trade receivables	5
Cash	7

The tax base of the identifiable net assets of Tigret was $40 million at 1 December 2009. The tax rate of Tigret is 30%.

(ii) On 30 November 2010,Tigret made a rights issue on a 1 for 4 basis. The issue was fully subscribed and raised $5 million in cash.

(iii) Jocatt purchased a research project from a third party including certain patents on 1 December 2009 for $8 million and recognised it as an intangible asset. During the year, Jocatt incurred further costs, which included $2 million on completing the research phase, $4 million in developing the product for sale and $1 million for the initial marketing costs. There were no other additions to intangible assets in the period other than those on the acquisition of Tigret.

(iv) Jocatt operates a defined benefit scheme. The current service costs for the year ended 30 November 2010 are $10 million. Jocatt enhanced the benefits on 1 December 2009 however, these do not vest until 30 November 2012. The total cost of the enhancement is $6 million. The expected return on plan assets was $8 million for the year and Jocatt recognises actuarial gains and losses within other comprehensive income as they arise.

(v) Jocatt owns an investment property. During the year, part of the heating system of the property, which had a carrying value of $0·5 million, was replaced by a new system, which cost $1 million. Jocatt uses the fair value model for measuring investment property.

(vi) Jocatt had exchanged surplus land with a carrying value of $10 million for cash of $15 million and plant valued at $4 million. The transaction has commercial substance. Depreciation for the period for property, plant and equipment was $27 million.

(vii) Goodwill relating to all subsidiaries had been impairment tested in the year to 30 November 2010 and any impairment accounted for. The goodwill impairment related to those subsidiaries which were 100% owned.

(viii) Deferred tax of $1 million arose on the gains on available-for-sale investments in the year.

(ix) The associate did not pay any dividends in the year.

Required:

(a) Prepare a consolidated statement of cash flows for the Jocatt Group using the indirect method under IAS 7 'Statement of Cash Flows'.

Note: Ignore deferred taxation other than where it is mentioned in the question.

(35 marks)

(b) Jocatt operates in the energy industry and undertakes complex natural gas trading arrangements, which involve exchanges in resources with other companies in the industry. Jocatt is entering into a long-term contract for the supply of gas and is raising a loan on the strength of this contract. The proceeds of the loan are to be received over the year to 30 November 2011 and are to be repaid over four years to 30 November 2015. Jocatt wishes to report the proceeds as operating cash flow because it is related to a long-term purchase contract. The directors of Jocatt receive extra income if the operating cash flow exceeds a predetermined target for the year and feel that the indirect method is more useful and informative to users of financial statements than the direct method.

(i) Comment on the directors' view that the indirect method of preparing statements of cash flow is more useful and informative to users than the direct method.

(7 marks)

(ii) Discuss the reasons why the directors may wish to report the loan proceeds as an operating cash flow rather than a financing cash flow and whether there are any ethical implications of adopting this treatment.

(6 marks)

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

(2 marks)

(50 arks)

Question 55 Margie (Q2 December 2010)

Margie, a public limited company, has entered into several share related transactions during the period and wishes to obtain advice on how to account for the transactions.

(a) Margie has entered into a contract with a producer to purchase 350 tonnes of wheat. The purchase price will be settled in cash at an amount equal to the value of 2,500 of Margie's shares. Margie may settle the contract at any time by paying the producer an amount equal to the current market value of 2,500 of Margie shares, less the market value of 350 tonnes of wheat. Margie has entered into the contract as part of its hedging strategy and has no intention of taking physical delivery of the wheat. Margie wishes to treat this transaction as a share based payment transaction under IFRS 2 'Share-based Payment'.

(7 marks)

(b) Margie has acquired 100% of the share capital of Antalya in a business combination on 1 December 2009. Antalya had previously granted a share-based payment to its employees with a four-year vesting period. Its employees have rendered the required service for the award at the acquisition date but have not yet exercised their options. The fair value of the award at 1 December 2009 is $20 million and Margie is obliged to replace the share-based payment awards of Antalya with awards of its own.

Margie issues a replacement award that does not require post-combination services. The fair value of the replacement award at the acquisition date is $22 million. Margie does not know how to account for the award on the acquisition of Antalya.

(6 marks)

(c) Margie issued shares during the financial year. Some of those shares were subscribed for by employees who were existing shareholders, and some were issued to an entity, Grief, which owned 5% of Margie's share capital. Before the shares were issued, Margie offered to buy a building from Grief and agreed that the purchase price would be settled by the issue of shares. Margie wondered whether these transactions should be accounted for under IFRS 2.

(4 marks)

(d) Margie granted 100 options to each of its 4,000 employees at a fair value of $10 each on 1 December 2007. The options vest upon the company's share price reaching $15, provided the employee has remained in the company's service until that time. The terms and conditions of the options are that the market condition can be met in either year 3, 4 or 5 of the employee's service.

At the grant date, Margie estimated that the expected vesting period would be four years which is consistent with the assumptions used in estimating the fair value of the options granted. The company's share price reached $15 on 30 November 2010.

(6 marks)

Required:

Discuss, with suitable computations where applicable, how the above transactions would be dealt with in the financial statements of Margie for the year ending 30 November 2010.

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

(2 marks)
(25 marks)

Question 56 Greenie (Q3 December 2010)
Greenie, a public limited company, builds, develops and operates airports.

(a) During the financial year to 30 November 2010, a section of an airport collapsed and as a result several people were hurt. The accident resulted in the closure of the terminal and legal action against Greenie. When the financial statements for the year ended 30 November 2010 were being prepared, the investigation into the accident and the reconstruction of the section of the airport damaged were still in progress and no legal action had yet been brought in connection with the accident. The expert report that was to be presented to the civil courts in order to determine the cause of the accident and to assess the respective responsibilities of the various parties involved, was expected in 2011. Financial damages arising related to the additional costs and operating losses relating to the unavailability of the building. The nature and extent of the damages, and the details of any compensation payments had yet to be established. The directors of Greenie felt that at present, there was no requirement to record the impact of the accident in the financial statements. Compensation agreements had been arranged with the victims, and these claims were all covered by Greenie's insurance policy. In each case, compensation paid by the insurance company was subject to a waiver of any judicial proceedings against Greenie and its insurers. If any compensation is eventually payable to third parties, this is expected to be covered by the insurance policies. The directors of Greenie felt that the conditions for recognising a provision or disclosing a contingent liability had not been met. Therefore, Greenie did not recognise a provision in respect of the accident nor did it disclose any related contingent liability or a note setting out the nature of the accident and potential claims in its financial statements for the year ended 30 November 2010.

(6 marks)

(b) Greenie was one of three shareholders in a regional airport Manair. As at 30 November 2010, the majority shareholder held 60·1% of voting shares, the second shareholder held 20% of voting shares and Greenie held 19·9% of the voting shares. The board of directors consisted of ten members. The majority shareholder was represented by six of the board members, while Greenie and the other shareholder were represented by two members each. A shareholders' agreement stated that certain board and shareholder resolutions required either unanimous or majority decision. There is no indication that the majority shareholder and the other shareholders act together in a common way. During the financial year, Greenie had provided Manair with maintenance and technical services and had sold the entity a software licence for $5 million. Additionally, Greenie had sent a team of management experts to give business advice to the board of Manair. Greenie did not account for its investment in Manair as an associate, because of a lack of significant influence over the entity. Greenie felt that the majority owner of Manair used its influence as the parent to control and govern its subsidiary.

(10 marks)

(c) Greenie has issued 1 million shares of $1 nominal value for the acquisition of franchise rights at a local airport. Similar franchise rights are sold in cash transactions on a regular basis and Greenie has been offered a similar franchise right at another airport for $2·3 million. This price is consistent with other prices given the market conditions. The share price of Greenie was $2·50 at the date of the transaction. Greenie wishes to record the transaction at the nominal value of the shares issued. Greenie also showed irredeemable preference shares as equity instruments in its statement of financial position. The terms of issue of the instruments give the holders a contractual right to an annual fixed cash dividend and the entitlement to a participating dividend based on any dividends paid on ordinary shares. Greenie felt that the presentation of the preference shares with a liability component in compliance with IAS 32 'Financial instruments: Presentation' would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the IASB's 'Framework for the Preparation and Presentation of Financial Statements'. The reason given by Greenie for this presentation was that the shares participated in future profits and thus had the characteristics of permanent capital because of the profit participation element of the shares.

(7 marks)

Required:

Discuss how the above financial transactions should be dealt with in the financial statements of Greenie for the year ended 30 November 2010.

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

(2 marks)
(25 marks)

Question 57 Whitebirk (Q4 December 2010)

(a) The principal aim when developing accounting standards for small to medium-sized enterprises (SMEs) is to provide a framework that generates relevant, reliable, and useful information which should provide a high quality and understandable set of accounting standards suitable for SMEs. There is no universally agreed definition of an SME and it is difficult for a single definition to capture all the dimensions of a small or medium-sized business. The main argument for separate SME accounting standards is the undue cost burden of reporting, which is proportionately heavier for smaller firms.

Required:

(i) **Comment on the different approaches which could have been taken by the International Accounting Standards Board (IASB) in developing the 'IFRS for Small and Medium-sized Entities' (IFRS for SMEs), explaining the approach finally taken by the IASB.**

(5 marks)

(ii) **Discuss the main differences and modifications to IFRS which the IASB made to reduce the burden of reporting for SME's, giving specific examples where possible and include in your discussion how the Board has dealt with the problem of defining an SME.**

(8 marks)

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

(2 marks)

(b) Whitebirk has met the definition of a SME in its jurisdiction and wishes to comply with the 'IFRS for Small and Medium-sized Entities'. The entity wishes to seek advice on how it will deal with the following accounting issues in its financial statements for the year ended 30 November 2010.The entity already prepares its financial statements under full IFRS.

(i) Whitebirk had capitalised borrowing costs of $100,000 onto the initial cost of a building valued at $600,000 including those borrowing costs on 1 December 2008. The life of the building was estimated at 10 years.

(ii) Whitebirk purchased 90% of Close, a SME, on 1 December 2009. The purchase consideration was $5·7 million and the value of Close's identifiable assets was $6 million. The value of the non-controlling interest at 1 December 2009 was estimated at $0·7 million. Whitebirk has used the full goodwill method to account for business combinations and the estimated life of goodwill cannot be estimated with any accuracy. Whitebirk wishes to know how to account for goodwill under the IFRS for SMEs.

(iii) Whitebirk has incurred $1 million of research expenditure to develop a new product in the year to 30 November 2010. Additionally, it incurred $500,000 of development expenditure to bring another product to a stage where it is ready to be marketed and sold.

Required:

Discuss how the above transactions should be dealt with in the financial statements of Whitebirk, with reference to the 'IFRS for Small and Medium-sized Entities'.

(9 marks)
(25 marks)

Answer 54 Jocatt SCF

Indirect cash flow statement (IAS7)

Profit before tax		59
Associate		(6)
Gain		(10.5)
Finance		6
Operating profit		48.5
Inventory	(128-105+0)	23
Receivables	(113-62+5)	56
Payables	(55-144+0)	89
Depreciation		27
Disposal of ppe (see note below)		0
Disposal of investment property heating		0.5
Disposal of AFS (see note below)		(1)
Impairment of goodwill		31.5
Impairment of intangibles		17
Pension service cost		12
Pension expected return on assets		(8)
Pension contribution (could be in investing)		(7)
Cash generated from operations		288.5
Interest paid	(0 – 0 + 6)	(6)
Tax paid		(16.5)
Operating cash flow		266
Investing		
Sub acquisition		(15)
Cash in hand		7
Intangible purchase		(8)
Intangible development		(4)
Investment property heating		(1)
Land sale		15
AFS purchase		(5)
Associate purchase		(48)
PPE purchase		(98)
Financing		
Borrowings repayment	(71-67)	(4)
Parent dividend (given)		(5)
NCI dividend (given)		(13)
NCI rights (given)		2
Cash flow		89
Opening		143
Closing		232

Workings

PPE

Opening	254
Closing	(327)
Revaluation	(7)
Acquisition	15
Disposal	(10)
Exchange	4
Depreciation	(27)
Cash flow purchases	(98)

Investment property

Opening	6
Closing	(8)
Heating disposal	(0.5)
Heating purchase	1
Gain (reported in superexceptional)	(1.5)

Goodwill

Opening	68
Closing	(48)
Goodwill on Tigret acquisition (see below)	11.5
Impairment	31.5

Intangibles

Opening	72
Closing	(85)
Acquisition	18
Purchase	8
Development	4
Impairment	17

Associate

Opening	0
Closing	(54)
I/S	6
Cash purchase	(48)

AFS (properly known as strategic equity investments)

Opening	90
Closing	(94)
Reclassification of 8% as sub consideration	(4)
Gain ($2m shown in oci net of deferred tax of $1m described in para (vii))	3
Cash flow purchases	(5)

Tax	
Opening CT	30
Closing CT	(33)
Opening DT	41
Closing DT	(35)
I/S	11
Acquisition (45-40)30% (see note below)	1.5
AFS DT (given)	1
Tax paid	16.5

Pension	
Opening	22
Closing	(25)
Loss (given in oci)	6
Current service cost (given in para (iv))	10
Past service cost $6m(1/3) (see note below)	2
Return on asset	(8)
Cash flow contributions	7

Goodwill on Tigret acquisition	
FV of consideration	30
FV of previous	5
FV of nci	20
FV of na (assets-dt=45-1.5)	(43.5)
Goodwill	11.5

Notes
These notes are purely for guidance and are certainly not required in the exam. Of course, they look at the tricky difficulties of this question and of course you would be expected to get all the following wrong in the exam. Forget it. You can easy score 30 without beating yourself up in the intricacies of this question.

Gain on property
The gain of $10.5m on property is the combination of the gain on the disposal of ppe and the gain on the rise in value of the investment property. The examiner does not make this clear. So alternative assumptions are acceptable. The gain on the investment property is $1.5m as calculated in the above working. The gain on the ppe is derived from para (vi) as $9m (sale proceeds of $15m plus $4m less exit carrying value of $10m). The gain is clearly recognised as a superexceptional below operating profit. This is why you do not remove it from operating profit in the operating profit reconciliation above.

Disposal of AFS
IFRS3 assumes that the 8% has been sold and bought back at $5m as it changes nature from a simple strategic investment in equity to a part of the cost of control of a sub. This would normally be no big deal, but because last years gain of $1m (from $4m cost to $5m fair value) was not recognised last year then it must have been recognised this year. The examiner has assumed that the profit on disposal ended up in operating costs and so has taken this non cash flow out of operating in the operating profit reconciliation.

NCI working
There is no need for an nci working as the examiner has shown the movement in nci in the socie.

Rights issue
The cash inflow into the sub is $5m, as given in para (ii). However, only $2m flows into the group from outside, as given in the socie. The other $3m flows from parent to 60% sub and so is simply an internal cash flow.
Acquisition deferred tax
Add down the list of assets acquired and you will see the carrying value is $45. The tax base is given in para (i) as $40m. The result is a temporary difference of $5m and deferred tax of $1.5m.

Pension
The pension is really tricky for many reasons. So be happy to get anything out of this area of the marking scheme. One difficulty is that the pension working is necessarily for the net liability, so the return on the asset, which makes the asset grow, makes the net liability shrink. But even more tricky is the past service cost. These usually vest immediately, in which case the related liability is recognised immediately. But when a past service cost vests over three years, then one third is recognised in the first year. The combined service cost in the income statement is the current $10m and past $2m combined. The examiner has assumed that the expected return on assets has been included in operating costs. This is wrong, but for simplicity I have made that assumption too and so removed the $8m from operating.