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CONCEPTUAL AND REGULATORY FRAMEWORK

Chapter 1

IASB CONCEPTUAL FRAMEWORK

The IASB Framework provides the underlying rules, conventions and definitions that underpin the preparation of all financial statements prepared under International Financial Reporting Standards (IFRS).

- Ensures standards developed within a conceptual framework
- Provide guidance on areas where no standard exists
- Aids process to improve existing standards
- Ensures financial statements contain information that is useful to users
- Helps prevent creative accounting

The revised IASB Conceptual Framework was issued in March 2018.

1. Objective of financial reporting

'Provide information that is useful to existing and potential investors, lenders and other creditors in making **decisions** about providing resources to the entity'

The decisions made by **users** will involve:

- Investment decisions
- Financing decisions
- Voting, or influencing management actions

The users will be assessing the management's stewardship of the entity alongside its prospects for the future, which will require the following information:

- Economic resources of the entity
- Claims against the entity
- Changes in the entity's economic resources and claims.
- Efficiency and effectiveness of management

2. Qualitative characteristics – make information useful

Fundamental qualitative characteristics

- Relevance – information that makes a difference to decisions made by users. Relevant information is that which is PREDICTIVE (of what may happen in the future), CONFIRMATORY (of what has happened in the past), and companies must have a policy as to what may or may not be MATERIAL.
- Faithful representation – must faithfully represent the substance of what it represents, and is therefore complete (helps understand and includes descriptions and explanations), neutral (no bias, and supported by the exercise of prudence) and free from error. Measurement uncertainty will impact the level of faithful representation.

Enhancing qualitative characteristics

- Comparability – identify similarities/differences between entities and year-on-year
- Verifiability – if information is verifiable, one would expect two professional accountants to agree that the numbers tie back to what is really happening (the economic phenomena).
- Timeliness – information is less useful the longer it takes to report it
- Understandability – users have a reasonable knowledge of business and activities

A cost constraint applies in ensuing that the information is useful, in that the benefit of obtaining the information should outweigh the cost of obtaining it.

3. Elements of financial statements

- **Assets**
  - Present economic resource
  - Controlled
  - Past events
- **Liabilities**
  - Present obligation
  - Transfer an economic resource
  - Past events
- **Equity**
  - Residual interest in assets less liabilities
- **Income**
  - Increase in asset
  - Reduction in liability
- **Expense**
  - Reduction in asset
  - Increase in liability

4. Recognition and derecognition

Recognition – the process of including an item in the financial statements and is appropriate if it results in relevant and faithful representation, provided that the cost of inclusion does not outweigh the benefit. Note that there is no requirement of probability. Under the Framework, it is conceivable that possible elements could be recognised.

Derecognition – the removal of all or part of an asset (loss of control)/liability (no obligation).

5. Measurement

Historic cost

This has the advantage of being easily verifiable.

Current value

1. Fair value – the price at which an asset would be sold or a liability settled. Sometimes known as an EXIT PRICE.

2. Current cost – the replacement cost of an asset in an equivalent condition. Sometimes known as an ENTRY PRICE.

6. Presentation and disclosure

Statement of profit or loss is the primary source of information for a company's performance, which includes all income and expense. If the income and expense arises from changes in current value then it may be appropriate to recognise it through other comprehensive income.

Reclassification of other comprehensive income to profit or loss is allowable if it gives more relevant information. This happens in rare circumstances (e.g. cash flow hedges) which will be covered later in these notes.

7. Conflicts between Framework and Accounting Standards

Where the Framework conflicts with accounting standards, the relevant accounting standard will take priority.

For example:

Provisions (e.g. for reorganisation) are recognised if PROBABLE (IAS 37). The Framework says that liabilities should be recognised subject to relevance and faithful representation, but does not refer to probability.

Goodwill is recognised in the SOFP (IFRS 3). It might be argued that it is not an asset at all if applying the definition in the Framework – it does not appear to be an 'economic resource controlled by the entity'.

Relevant examiner articles on the ACCA (students) website:

The Conceptual Framework

Measurement

PUBLISHED COMPANY ACCOUNTS

Chapter 2

PRESENTATION OF FINANCIAL STATEMENTS (IAS 1)

Financial statements will present to the users of accounts:

- Statement of financial position
- Statement of profit or loss and other comprehensive income
- Statement of changes in equity
- Statement of cash flows
- Notes to the accounts
- Comparatives

Financial statements should provide a fair presentation of the results, which is achieved by compliance with IFRSs.

Statement of financial position as at [date]

	$'000s	*$'000s*
ASSETS		
Non-current assets		
Property, plant and equipment		X
Intangibles		X
Financial assets		X
		X
Current assets		
Inventories	X	
Trade and other receivables	X	
Financial assets	X	
Cash and cash equivalents	X	
	X	
Non-current assets held for sale	X	
		X
Total assets		X
EQUITY AND LIABILITIES		
Equity		
Equity shares ($1)		X
Retained earnings		X
Other components of equity		X
Total equity		X
Non-current liabilities		
Long term borrowings	X	
Lease liabilities	X	
Deferred tax	X	
Retirement benefit liability	X	
		X
Current liabilities		
Trade and other payables	X	
Dividends payable	X	
Tax payable	X	
Lease liabilities	X	
		X
Total equity and liabilities		X

Statement of profit and loss and other comprehensive income for the year ended [date]

Continuing operations	***$'000s***
Revenue	X
Cost of sales	(X)
Gross profit	X
Distribution expenses	(X)
Administrative expenses	(X)
Operating profit	X
Finance costs	(X)
Investment income	X
Profit before tax	X
Income tax expense	(X)
Profit from continuing operations for the period	X
Discontinued operations	
Profit/(loss) for the period from discontinued operations	X
Profit/(loss) for the period	X
Other comprehensive income for the year (after tax):	
Items that will not be reclassified to profit or loss:	
Gain on non-current asset revaluations	X
Gain/(loss) on fair value through other comprehensive income investment	X/(X)
Re-measurement gain/(loss) on defined benefit plan	X/(X)
	X
Items that may be reclassified subsequently to profit or loss:	
Ineffective element of gain/(loss) on cash flow hedge	X/(X)
Exchange difference on translation of foreign subsidiary	X/(X)
Other comprehensive income, net of tax	X
Total comprehensive income for the period	X

Statement of changes in equity for the year ended [date]

	Equity shares	***Retained earnings***	***Other components of equity***	***Total***
	$'000s	***$'000s***	***$'000s***	***$'000s***
B/f	X	X	X	X
Issue of share capital	X	-	-	X
Dividends	-	(X)	(X)	(X)
Total comprehensive income for the year	-	X	X	X
Transfer to retained earnings	-	X	(X)	-
C/f	X	X	X	X

Disclosure points

1. Companies must disclose their material accounting policies. (An earlier version of IAS 1 used the phrase significant accounting policies).

2. Notes must be presented in a systematic manner and cross-referenced.

3. The notes must disclose key judgements made in applying accounting policies.

GROUP ACCOUNTS

Chapter 3

BASIC GROUP STRUCTURES

1. Subsidiary

A subsidiary is an entity that is controlled by another entity (parent).

Control means:

- Power to direct relevant activities of investee AND
- Exposure or rights to variable returns from involvement with investee AND
- Ability to use power over investee to affect amount of investor's returns

An entity has control over an entity when it has the power to direct the activities, which is assumed to be when the entity has > 50% of the voting rights.

The parent company must prepare consolidated financial statement if it has control over one or more subsidiaries.

Note however that IFRS 3 requires that there is a genuine business combination (or combination of two or more businesses!). A business must have:

- Inputs (e.g. wood)
- A substantive process (e.g. a machine and an employee to switch the machine on)
- The ability to create outputs (e.g. chairs).

Therefore, if the parent buys a company which simply holds an asset (e.g. PPE) and does nothing with it, it would not be a business. IFRS 3 refers to this as the 'concentration test' – if all of the value of the entity is concentrated in a single asset – then there may be no business.

The underlying principles of consolidation are:

- Substance over legal form
- Control and ownership

Other situation where control exists are when the investor:

- Can exercise the majority of the voting rights in the investee
- Is in a contractual arrangement with others giving control
- Holds < 50% of the voting rights, but the remainder are widely distributed
- Holds potential voting rights which will give control

2. Associate

An associate is where an entity has significant influence over the associated company.

Significant influence is the power to participate in the financial and operating policy decisions. It is presumed that an investment of between 20% and 50% indicates the ability to significantly influence the investee.

Other situations where significant influence exists are when the investor:

- Representation on the board
- Participation in policy making process
- Material transaction between the two entities
- Interchange of managerial personnel
- Provision of essential technical information

Example 1 – Influence

Vader acquired 19.9% of the equity share capital of Ren at the start of the financial year. As part of the investment Vader has two out of the eight seats on the board of directors.

Advise Vader how it should account for the investment in Ren in its financial statements.

3. Consolidated statement of financial position

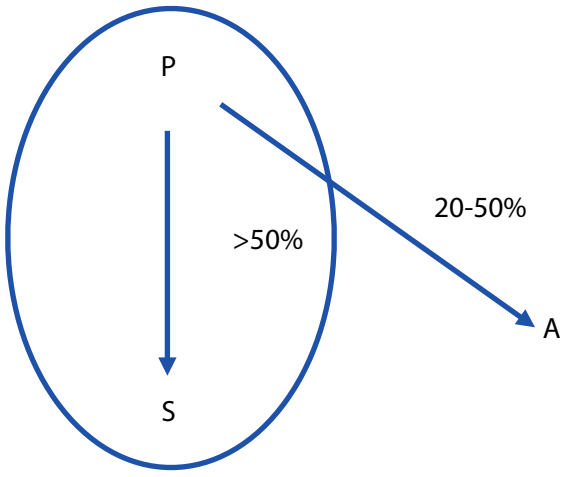
In this exam you will not be asked to prepare an entire SOFP. However, you might be asked to calculate key figures such as:

- **Goodwill**
- **Non-controlling interest**
- **Retained earnings.**

You may find it useful to refresh your knowledge of consolidation techniques from our ACCA Financial Reporting Course Notes.

Note that this proforma assumes that NCI is measured at fair value

Group Structure



Goodwill

FV of consideration (shares/cash/loan stock)	X
NCI at acquisition	X
	X
FV of net assets at acquisition	(X)
Goodwill at acquisition	X
Less: impairments to date	(X)
Goodwill (carrying value)	X

Non-controlling interests

NCI @ acqⁿ	X
Add: NCI% x S's post-acqⁿ profits	X
Less: NCI% x impairment to date	(X)
	X

Group retained earnings

100% P	X
Add: P's % of S's post acqⁿ retained earnings	X
Add: P's % of A's post acqⁿ retained earnings	X
Less: P's% x impairment to date in subsidiary	(X)
Less: Impairment to date (associate)	(X)
	X

Investment in associate

Cost	X
Add: P% x A's post-acqⁿ profits	X
Less: Impairment to date (100%)	(X)
	X

4. Adjustments – group and subsidiary

Intra-company balances

- Remove the payable
- Remove the receivable

Unrealised profits

Inventory PUP

Need to remove the intra-group profit included in inventory held @ year-end

Cr Inventory (SFP)	X
Dr Retained earnings (of seller)	X

5. Other issues

Cost of investment

- Cash
  - now (@ price paid/share)
  - deferred (@PV)
  - contingent (@FV)
- Shares

  Measure at FV on the date that the parent buys the subsidiary.

Transaction costs

Transaction costs, such as legal fees, must be expensed in the P&L. They cannot be capitalised.

Non-controlling interest

Can either be measured at fair value (full goodwill) or as the NCI share of the subsidiaries' net assets acquired (partial or proportionate goodwill)

Net assets of subsidiary acquired

Must be measured at fair value. This may result in the recognition of assets or liabilities that would not have been recognised in the subsidiary's own financial statements. For example:

- Internal brand name would be recognised as an asset in the group accounts at FV.
- Contingent liability (even if only possible) would be recognised as a liability in the group accounts at FV.

Negative goodwill

Must be credited in the group profit and loss account.

Adjustment period

When a parent company takes over a subsidiary, it will take some time to assess the fair value of the net assets. Therefore, there is a 12 month 'window' during which the parent company can revise these fair values. In summary, goodwill may change in the first 12 months.

Mid-year acquisitions

Calculate the subsidiary's retained earnings at acquisition, assuming subsidiary profits in the year accrue evenly.

Uniform accounting policies

Subsidiary must adopt the parent's accounting policies in the group accounts. Accounted for by adjusting the value of assets/liabilities.

Non-coterminous year-ends

Financial statements within three months of the parents year-end can be used and adjusted for any significant events.

6. Adjustments - group and associate

Trading transactions – do not eliminate the balances

Unrealised profits – adjust for P's% of any PUP

Example 2 – Basic consolidation (revision)

Rey, a public limited company, operates in the manufacturing sector.

The draft statements of financial position at 31 December 2015 are as follows:

	Rey	*Finn*
	$m	*$m*
Assets:		
Non-current assets		
Property, plant and equipment	1,560	1,250
Investments	1,540	
	3,100	1,250
Current assets:		
Inventory	450	580
Receivables	380	390
Cash	190	230
	1,020	1,200
Total assets	4,120	2,450
Equity and liabilities:		
Share capital	1,700	1,000
Retained earning	1,450	800
Total equity	3,150	1,800
Non-current liabilities	520	350
Current liabilities		
Trade payable	300	190
Tax payable	150	110
	450	300
Total liabilities	970	650
Total equity and liabilities	4,120	2,450

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

On 1 January 2014, Rey acquired 70% of the equity interest of Finn for a cash consideration of $1,340 million. At 1 January 2014, the identifiable net assets of Finn had a fair value of $1,850 million, and retained earnings were $450 million. The excess in fair value is due to an item of property, plant and equipment that has a remaining useful life of 10 years.

It is the group policy to measure the non-controlling interest at acquisition at is proportionate share of the fair value of the subsidiary's net assets.

On 1 July 2015, Rey acquired 25% of the equity interest of Ben for a cash consideration of $200 million. Ben's profits for the year were $80 million. The 25% holding gives Rey the power to participate in the operating and financing decisions of Ben.

Prepare the following workings as at 31 December 2015:

(a) Goodwill
(b) Associate
(c) Non-controlling interest (NCI)
(d) Retained earnings

7. Other components of equity

Other components of equity is an additional reserve that constitutes any reserve that does not go into retained earnings. It could therefore include share premium, revaluation reserve, gains/losses on fair value through other comprehensive income investments.

In the group accounts it is treated in exactly the same way as the group retained earnings, i.e. 100% P plus P's% x S's post acquisition movement.

Example 3 – Other components of equity

Luke, a public limited company, operates in the manufacturing sector. The draft statements of financial position at 31 December 2015 are as follows:

	Luke	*Han*
	$m	*$m*
Assets:		
Non-current assets		
Property, plant and equipment	3,650	2,480
Investment in Han	5,400	
	9,050	2,480
Current assets:		
Inventory	1,950	1,480
Receivables	1,780	1,090
Cash	370	285
	4,100	2,855
Total assets	13,150	5,335
Equity and liabilities:		
Share capital	5,500	2,000
Retained earning	3,200	1,000
Other components of equity	1,000	625
Total equity	9,700	3,625
Non-current liabilities	500	240
Current liabilities		
Trade payable	1,900	1,020
Tax payable	1,050	450
	2,950	1,470
Total liabilities	3,450	1,710
Total equity and liabilities	13,150	5,335

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

- On 1 January 2015, Luke acquired 80% of the equity interest of Han for a cash consideration of $5,400 million. At 1 January 2015, the identifiable net assets of Han had a fair value of $3,400 million, and retained earnings were $600 million and other components of equity were $400 million. The excess in fair value is due to an item of non-depreciable land.
- The fair value of the non-controlling interest at the date of acquisition was $700m.

(a) Calculate the goodwill using (i) the proportionate share of net assets method, and (ii) the fair value method.

(b) Calculate the group other components of equity.

Consolidated statement of profit and loss and other comprehensive income

X/12

	P	*S*	*Adj.*	*Group*
Revenue	X	X	(X)	X
COS	(X)	(X)	X	
-PUP (Inventory)	(X)	(X)		(X)
-FV adj (extra depⁿ)		(X)		
Gross profit				X
Dist costs	(X)	(X)		(X)
Admin exp.	(X)	(X)		
-Impairment		(X)		(X)
Finance cost	(X)	(X)	X	(X)
Investment income	X	X	(X)	X
-Dividend from S/A	(X)			
Associate (P's % x A's PFY) - impairment				X
Profit before tax				X
Taxation	(X)	(X)		(X)
PFY		X		X
Revaluation gain	X	X		X
Associate				X
TCI		X		X
				X

NCI

Remember that the group accounts must separately disclose:

1. PAT attributable to NCI (NCI % of S's PAT)
2. TCI attributable to NCI (NCI% of S's TCI)

Example 4 – Group SPLOCI (revision)

	Vader	*Maul*
	$m	*$m*
Revenue	1,645	1,280
Cost of sales	(1,205)	(990)
Gross profit	440	290
Distribution costs	(100)	(70)
Administrative expenses	(90)	(50)
Profit before interest and tax	250	170
Finance costs	(55)	(30)
Profit before tax	195	140
Taxation	(35)	(28)
Profit for the year	160	112
Revaluation gain	100	50
Total comprehensive income	260	162

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

On 1 July 2015, Vader acquired 80% of the equity shares of Maul, a public limited company, for a cash consideration of $90 million. The fair value of the identifiable net assets acquired was $85 million and the fair value of the non-controlling interest was $25 million. The fair value of the net assets at acquisition was not materially different to their book value.

On 1 January 2015 Vader acquired 25% of the equity shares of Sith and exerted significant influence through its representation on the board of directors. Sith's profits for the year were $100 million.

It is the group policy to measure the non-controlling interest at acquisition at fair value.

Goodwill has been impairment tested at year-end and found to have fallen in value by 20% in Vader. Goodwill impairments are recorded in administrative expenses.

Vader sold goods to Maul for $20 million at fair value following the acquisition.

Maul revalued its land and buildings at the year-end and recorded a revaluation surplus of $50 million through other comprehensive income.

No dividends were declared by any company during the year.

Assume that profits accrue evenly during the year.

Calculate the following figures for year ended 31 December 2015.

(a) Group revenue
(b) Goodwill on Maul
(c) Group admin expenses
(d) Group other comprehensive income
(e) Share of profit of associate
(f) NCI in PAT of Maul

8. Disclosure of interest in other entities (IFRS 12)

IFRS 12 requires that a parent discloses the significant assumptions and judgement used in determining whether control exists over an investee.

The parent will therefore list all the entities it has a relationship with and explain the basis of the accounting treatment.

Structured entity

IFRS 12 defines a structured entity as one in which voting rights are not the dominant factor in determining control.

For example, A might own only 5% of the shares of B, but controls the company through a 'control contract'. In this case, if the company is not consolidated, the 'acquiring' company must at least make full disclosure of its relationship with the other company.

9. Impairments and group accounts

An asset/CGU is impaired if the carrying amount is greater than the recoverable amount.

The recoverable amount is the **higher** of the value in use and the fair value less costs to sell.

Impairment – Subsidiary (full goodwill)

The subsidiary is treated as a cash generating unit, where the carrying value is that of the subsidiary plus any goodwill.

Example 5 – Subsidiary impairment (full goodwill)

Dublin acquired 60% of the equity share capital of Fairyhouse on 1 January 2015 for $20million. The fair value of the identifiable net assets at that date was $25million and the fair value of the non-controlling interest was $15million.

Fairyhouse made profits for the year-ended 31 December 2015 of $5million. Its value in use was calculated as $38million and is fair value less costs to sell as $36million.

Calculate the impairment in the subsidiary to be recognised in the group financial statements of Dublin as at 31 December 2015.

In the example above if the goodwill is measured under the full goodwill method then the impairment is split between the parent and the NCI based upon the ownership percentages as the goodwill consists of the parent's goodwill and NCI goodwill. The journal entry would be as follows:

DR Retained earnings – P's % of the impairment

DR NCI – NCIs % of the impairment

CR Goodwill – 100% of the impairment

Impairment – subsidiary (partial goodwill)

If goodwill is measured using the proportionate share method the goodwill calculated consists of the partial goodwill (P's share) and the impairment is allocated entirely to the group retained earnings as there is no NCI share of goodwill.

The calculation of the impairment becomes slightly more complex as the carrying value of the subsidiary needs to reflect the net assets of the subsidiary plus the full goodwill, as the recoverable amount used is that of the entire subsidiary. The issue is that the goodwill figure reflects the partial goodwill, i.e. only the parent's share and not the full goodwill, so the partial goodwill will therefore need to be grossed up to an equivalent full goodwill amount so that the impairment is calculated on the full value of the subsidiary (S's net assets

plus grossed up goodwill). This carrying value can then be compared to the recoverable amount as normal to calculate the impairment.

Note that the grossing up is only for the purpose of the calculation of the impairment. The grossing up is not recorded in the ledger or the financial statements.

Illustration – Subsidiary impairment (partial goodwill)

Belfast acquired 80% of the equity share capital of Dundalk on 1 January 2018 for $60 million. The fair value of the identifiable net asset at that date was $40 million and goodwill is measured using the proportionate share method.

Goodwill is therefore calculated as follows:

	$ million
Fair value of consideration	60
NCI at acquisition	8
Net assets at acquisition	(40)
Goodwill at acquisition	28

Dundalk made profits for the year-ended 31 December 2018 of $10 million and the annual impairment review revealed the recoverable amount to be $45 million.

The subsidiary is impaired if the carrying value of the subsidiary is greater than the recoverable amount. The carrying value of the subsidiary will be equal to the net assets at the reporting date plus the grossed-up goodwill, using the ownership percentages.

Net assets at reporting date	=	Net assets at acquisition + profit for the year $40 million + $10 million $50 million
Grossed-up goodwill	=	Partial goodwill (80%) + NCI goodwill (20%) $28 million + (20/80 x $28 million) $35 million
Carrying value	=	$85 million

The subsidiary is therefore impaired by $40 million. $35m of the loss is allocated to goodwill and the remaining $5m of the loss is allocated to the other net assets of the subsidiary.

The final journal is:

CR Goodwill (80% of 35)	28
CR S's Other net assets	5
DR Profit or loss balancing figure)	33

Impairment – Associate

The associate is treated as an asset, where the value of the asset is the value of the investment in associate.

Example 6 – Associate impairment

Cork acquired 25% of the equity share capital of Navan on 1 January 2015 for $5million and exerts significant influence over it. Navan made profits for the year-ended 31 December 2015 of $2million and did not declare any dividends during the year.

Cork impairment tested Navan at the end of the year, whereby the fair value less costs to sell were $16million and the value in use was $20m.

Calculate the value of Navan to appear in the Cork group consolidated statement of financial position at 31 December 2015.

10. Final points

Exemption from the preparation of group accounts

A company need not prepare consolidated accounts if it meets all of the following conditions:

- It is a subsidiary of another company
- It is not listed on a Stock Exchange
- It's parent produces group accounts.

Thus, if Company A owns Company B which owns Company C, then Company B would not have to prepare group accounts.

Carrying amount of a subsidiary or associate in the parent's financial statements

Any of the following can be used:

- Cost
- Fair value
- Equity accounting

Relevant examiner articles on the ACCA (students) website:

Impairment of goodwill

Chapter 4

JOINT ARRANGEMENTS (IFRS 11)

A joint arrangement is an arrangement where two or more parties have joint control over an entity under a contractual agreement.

- Joint venture
- Joint operation

Each party will normally have a right of veto over key decisions.

Joint venture

A joint venture is whereby the parties have rights to the net assets of the arrangement. A separate entity is created and each of the venturers hold shares in the new entity.

The accounting for the arrangement is done using equity accounting.

Joint operation

A joint operation is whereby the parties have rights to the assets and obligations for the liabilities of the arrangement

The accounting for the arrangement is done by each party recording their share of the arrangements assets and liabilities in their own statement of financial position and their share of revenue and costs in their own statement of profit or loss.

Example 1 – Joint operation

Lyon has a 40% share of a joint operation, a natural gas station. The following information relates to the joint arrangement activities:

- The natural gas station cost $15 million to construct and was completed on 1 January 2015. Its useful life is estimated at 10 years.
- In the year, gas with a direct cost of $22 million was sold for $30 million. Additionally, the joint arrangement incurred operating costs of $1.5 million during the year.
- Assets, liabilities, revenue and costs are apportioned on the basis of the shareholding.

Lyon has only contributed and accounted for its share of the construction cost, paying $6 million. The revenue and costs are receivable and payable by the other joint operator who settles amounts outstanding with Lyon after the year-end (31 December 2015)

Show how Lyon would account for the above in its consolidated financial statements for the year ended 31 December 2015.

Chapter 5

CHANGES IN GROUP STRUCTURE

A group structure can change if the parent company either buys more shares in an entity or sells shares of an entity.

1. Step acquisition

An investment in an entity will, in practice, be bought in stages over a period of time

No control -> control

In this situation A may own 10% or 30% of B. It then buys an additional 50%, taking it over the 'control threshold'. IFRS 3 requires that goodwill is calculated in the event of the control threshold being crossed. Furthermore the goodwill calculation must use the FAIR VALUE of consideration as measured on the DATE THAT CONTROL IS ACHIEVED.

The accounting treatment is to treat the original investment as being disposed of at fair value and re-acquired at fair value. The fair value on re-acquisition plus the extra consideration paid for the additional new shares bought, becomes the cost of the increased investment.

1. Re-measure original investment to fair value and gain to profit or loss
2. Calculate goodwill

Sometimes the gain or loss is recognised in other comprehensive income. (We will discuss later how different investments can be classified – this will be dealt with in the chapter on financial instruments).

(W) Goodwill

	$m
Cost of additional investment	X
Fair value of existing interest	**X**
NCI at acquisition	X
Fair value of S's net assets at acquisition	(X)
Goodwill at acquisition	X

Example 1

Jeremy acquired 40% of the equity interest of David for $40 million several year ago. On the 1 January 2015, Jeremy acquired an additional 35% for $45 million when the fair value of the identifiable net assets were $105 million. The investment was classified as fair value through profit or loss.

The fair value of the non-controlling interest on 1 January 2015 was $32 million the fair value of the original 40% holding was $52 million.

Calculate the goodwill to appear in the Jeremy group statement of financial position as at 31 December 2015.

Control -> control (change in ownership)

In this situation A may own 60% of B. It then buys an additional 10%. Note that there is no change in control. All that is happening is that the NCI will get smaller (from 40% to 30%). NO FURTHER GOODWILL IS CALCULATED. Instead the transaction is seen as a transaction with the NCI shareholders. Two things will change:

1. NCI goes down.
2. Cash goes down.
3. There will be a difference – this is known as the 'difference' or 'adjustment' It is posted to reserves – there is no impact on P&L or OCI. You might almost say that it is being 'swept under the carpet'.

Example 2

A owns 75% of B. On 31 December, when the NCI has a carrying amount of 75, it then buys the remaining 25% shares for 100.

Prepare the journal entry for this transaction.

3. Step disposals

Control -> control (change in ownership)

In this situation A may own 80% of B. It then sells 10%. Note that there is no change in control. All that is happening is that the NCI will get larger (from 20% to 30%). NO PROFIT ON DISPOSAL IS CALCULATED. Instead the transaction is seen as a transaction with the NCI shareholders. Two things will change:

1. NCI goes up.
2. Cash goes up.

There will be a difference – this is known as the 'difference' or 'adjustment' It is posted to reserves – there is no impact on P&L or OCI.

DR	Bank	X
CR	Non-controlling interest	X
DR/CR	Retained earnings (balancing figure)	X

Example 3

Betty owned 100% of the equity shares of Penny before it then sold 10% of the subsidiary on 31 December 2015 for $50 million.

The net assets at the date of disposal of the shares was $350 million and the goodwill on acquisition of the original holding was $50 million.

Assume that the goodwill is 'full' goodwill'.

Prepare the journal entry to record the change in ownership from a 100% holding to a 90% holding.

Control -> no control

In this situation A owns 80% of B. It then sells 45%, leaving a holding of 35%. The control threshold (50%) has been crossed. IFRS 3 requires that a profit (or loss) on the loss of control must be recorded in the P&L.

Calculation:

(W) Group profit/loss on disposal

		$m
Sale proceeds of 45%		X
Fair value of remaining shares (35%)		X
Less: Sub sold:		
Net assets	X	
Goodwill	(X)	
NCI	(X)	
		(X)
		X

Example 4

Socks owned 90% of Mogs before it decided to sell a 50% stake of its investment on 31 December 2015 for $120 million. The non-controlling interest at that date was $53 million and the fair value of the remaining 40% is $96 million.

The goodwill on acquisition of the original 90% holding was $38 million and the net assets at the date of disposal were $201 million.

Calculate the group profit on disposal that will appear in the group financial statements of Socks group for the year-ended 31 December 2015.

Example 5 – Group SFP

Reilly, a public limited company, operates in the manufacturing sector. The draft statements of financial position at 31 December 2015 are as follows:

	Reilly $m	*Hulme* $m	*Jones* $m
Non-current assets	180	115	100
Investment in Hulme	90	-	-
Investment in Jones	85	-	-
Current assets	80	90	60
Total assets	435	205	160
Share capital	250	80	75
Retained earning	110	65	45
Other components of equity	10	-	-
Non-current liabilities	15	14	10
Current liabilities	50	46	30
Total equity and liabilities	435	205	160

The following information is relevant in preparing the group financial statements of the Reilly Group.

Reilly acquired a 60% holding in the equity shares of Hulme on 1 January 2014 for a cash consideration of $75million, when the retained earnings were $25 million. The fair value of the non-controlling interest was $40 million.

On the 31 December 2015, Reilly acquired a further 10% of the equity shares of Hulme for a cash consideration of $15million. At this date the NCI was $56m.

Reilly acquired a 90% of the equity shares of Jones on 1 January 2015 for a cash consideration of $120 million when the retained earnings were $35 million. The fair value of the non-controlling interest was $13 million

On 31 December 2015, Reilly disposed of 20% of the equity shares in Jones for a cash consideration of $35 million. At this date the NCI was $14m.

The group policy is to value the non-controlling interest at acquisition using the fair value method.

Calculate for inclusion in the consolidated statement of financial position of the Reilly Group as at 31 December 2015 the following balances (i) Goodwill, (ii) The difference posted to retained earnings in respect of the share transactions on 31 December 2015.

Example 6 – Group SPL

	Maryland	*Tansey*
	$m	*$m*
Revenue	2,468	1,664
Cost of sales	(1,808)	(1,287)
Gross profit	660	377
Other expenses	(285)	(156)
Profit before interest and tax	375	221
Finance costs	(83)	(39)
Profit before tax	292	182
Taxation	(53)	(36)
Profit for the year	239	146

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

Maryland acquired 75% of the equity share capital of Tansey on 1 January 2012. On 1 April 2015, Maryland disposed of a 10% holding in Tansey.

Calculate the non-controlling interest in the Maryland Group consolidated statement of profit and loss for the year ended 31 December 2015.

Example 7

Harry Co owns 90% of the shares in Matthew Co. Harry Co originally acquired 25% of the shares many years ago. Last year Harry Co acquired a further 55% to take its holding to 80%. In the current year Harry Co acquired a further 10% to take its holding to 90%.

Explain how the accounting treatment for Matthew Co should have been accounted for each time Harry acquired shares.

A note about associates

Note that the principles set about above apply equally to the acquisition or loss of significant influence.

Thus, for example, if a company owns 40% of another company, and then sells 25% (losing significant influence), there will be a profit or loss recognised in the profit and loss account:

	$M
Proceeds of sale	X
Fair value of 15% retained	X
Less: Carrying amount of 40% associate	(X)
To profit and loss account	X

Relevant examiner articles on the ACCA (students) website:
Business combinations – IFRS 3 (revised)

Chapter 6

FOREIGN CURRENCY (IAS 21)

1. Functional currency

Currency of the primary economic environment in which the entity operates. This is deemed to be where the entity generates and expends cash.

Management should consider the following factors in determining the functional currency:

- The currency that dominates the determination of the **sales prices**
- The currency that most influences **operating costs**
- The currency in which an **entity's finances** are denominated is also considered.

If an entity has transactions that are denominated in a currency other than its functional currency then the amount will need to be translated into the functional currency before it is recorded within the general ledger.

Individual company accounts

Record the transaction at the exchange rate in place on the date the transaction occurs.

Monetary assets and liabilities are retranslated using the closing rate at the reporting date, with any gains or losses going through profit or loss.

Non-monetary assets and liabilities are not retranslated at the reporting date, unless carried at fair value, whereby translate at the rate when fair value was established.

Note: No specific guidance is given as to where any exchange differences are recorded within profit or loss. The general accepted practice is:

- Trading transaction – operating costs
- Financing transaction – financing costs

Example 1

Jones Inc. has its functional currency as the $USD.

It trades with several suppliers overseas and bought goods costing 400,000 Dinar on 1 December 2015. Jones paid for the goods on 10 January 2016.

Jones's year-end is 31 December. The exchange rates were as follows:

1 December 2015	4.1 Dinar : $1USD
31 December 2015	4.3 Dinar : $1USD
10 January 2016	4.4 Dinar : $1USD

Show how the transaction would be recorded in Jones's financial statements.

Example 2

Flower Inc. acquired an item of property, plant and equipment on 1 January 2011 at cost of 72 million dinars. The property is depreciated straight-line over 25 years, with nil residual value. At 31 December 2015, the property was revalued to 95 million dinars. The following exchange rates are relevant to the preparation of the financial statements:

1 January 2011	3.6 Dinar : $1USD
31 December 2015	4.3 Dinar : $1USD

Show how the transaction would be recorded in Flower's financial statements for the year-ended 31 December 2015.

2. Group accounts

If a group has a subsidiary company that is located overseas, that subsidiary will have a different functional currency to the rest of the group. Before consolidation of the subsidiary its results will need to be correctly stated in its functional currency. Once this has been done the results can then be translated into the presentational currency of the group and consolidated.

Group SFP

- Translate all the assets and liabilities of the subsidiary @ closing rate (CR)
- Goodwill working in overseas currency and translate at the closing rate
- Calculate the exchange differences in the subsidiary.

	Rate	*$m*
Non-current assets	@CR	X
Current assets	@CR	X
Non-current liabilities	@CR	(X)
Current liabilities	@CR	(X)
Net assets		X
Equity share capital	@HR	X
Reserves		
Pre-acquisition	@HR	X
Post-acquisition	(β)	X
Equity		X

Group P/L and OCI

Translate all the income and expenses of the subsidiary @ average rate (AR)

Example 3

Statements of profit or loss for the year-ended 31 December 2015

	Holly	*Ivy*
	$m	*Dinars m*
Revenue	247	1,664
Cost of sales	(181)	(1,288)
Gross profit	66	376
Expenses	(29)	(156)
Profit before interest and tax	37	220
Finance costs	(8)	(40)
Profit before tax	31	180
Taxation	(5)	(50)
Profit for the year	26	130

Statements of financial position at 31 December 2015

	Holly	*Ivy*
	$m	*Dinars m*
Non-current assets	200	500
Investment in Ivy	200	-
Current assets	90	390
Total assets	490	890
Share capital	250	350
Retained earning	110	280
Non-current liabilities	80	65
Current liabilities	50	195
Total equity and liabilities	490	890

The following information is relevant to the preparation of the consolidated financial statements of Holly.

On 1 January 2015, Holly acquired 80% of the equity share capital of Ivy for a consideration of Dinars 760 million when the retained earnings were Dinars 150 million.

The non-controlling interest is valued using the proportionate share of net assets method.

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

	Dinars to $
1 January 2015	3.8
31 December 2015	4.3
Average rate for the year to 31 December 2015	4.0

Calculate for inclusion in the group statement of financial position of the Holly Group at 31 December 2015 the following balances: (i) Goodwill, (ii) Post-acquisition reserves of the subsidiary, (iii) Non-controlling interests, and (iv) Group retained earnings.

Gain or loss on translation of the overseas subsidiary

The subsidiary's financial statements are translated using different exchange rates, being the opening and closing rate for net assets and average rate for profit or loss items. This gives rise to exchange gains or losses each year as we translate the subsidiary at year-end.

			$m
Opening net assets			
	@ OR	X	
	@ CR	X	
			X
Profit for the year			
	@ AR	X	
	@ CR	X	
			X
Goodwill			
	@ OR	X	
	@ CR	X	
			X
Translation gain/loss			X

Any gains or losses on translation of the overseas subsidiary are recognised in other comprehensive income.

Example 4 – Gain or loss on translation of the overseas subsidiary

Continuing from the previous example, calculate the gain or loss on translation of the overseas subsidiary.

Disposal of foreign subsidiary

Note that, on disposal of a foreign subsidiary, the cumulative exchange differences previously recognised in OCI are recycled to the profit and loss account. The exchange differences are now said to be 'realised'. For example, if the exchange differences were gains, the journal would be as follows:

Dr OCI (cumulative exchange differences) X

Cr Profit and loss account X

Relevant examiner articles on the ACCA (students) website:

IAS 21 – Does it need amending?

Chapter 7

GROUP STATEMENT OF CASH FLOWS

Consolidated statement of cash flows for the year ended [date]

	$m	*$m*
Operating Activities		
Group Profit Before Tax	X	
Depreciation	X	
Impairment	X	
Gain/Loss on Disposal of Tangibles	(X)/X	
Gain/Loss on Sale of Subsidiary	(X)/X	
Share of Associates Profit	(X)	
Interest Payable	X	
Inventory	(X)/X	
Receivables	(X)/X	
Payables	X/(X)	
Cash generated from operations	X	
Interest Paid	(X)	
Tax Paid	(X)	
Cash generated from operating activities		X
Investing Activities		
Sale Proceeds from Tangibles	X	
Purchase of Tangibles	(X)	
Dividend Received from Associate	X	
Acquisition/Disposal of Sub	(X)/X	
Dividends Received	X	
Cash generated from investing activities		X
Financing Activities		
Proceeds from Share Issue	X	
Loan Issue/Repayment	X/(X)	
Dividend paid to NCI	(X)	
Dividend paid to parent shareholders	(X)	
Cash generated from financing activities		X
Change in cash and cash equivalents		X/(X)
Opening cash and cash equivalents		X
Closing cash and cash equivalents		X

3. Dividend paid to the non-controlling interest

Non-controlling interest

		B/f	X
Dividend paid (β)	X	Profit	X
Disposal of sub.	X	Acquisition of sub.	X
C/f	X		
	X		X

Example 1 – Dividend paid to non-controlling interest

Group statement of profit or loss for the year-ended 31 December 2015 (extract)

	$m
Profit before tax	91
Taxation	(31)
Profit for the year	60
Attributable to:	
Ordinary shareholders of the parent	54
Non-controlling interest	6

Group statement of financial position as at 31 December 2015 (extract)

	2015 *$m*	*2014* *$m*
Equity		
Non-controlling interests	115	110

Calculate the dividend paid to the non-controlling interests to appear in the group statement of cash flows for the year-ended 31 December 2015.

4. Dividend received from associate

Associate

B/f	X		
Profit	X	Dividend paid (β)	X
		C/f	X
	X		X

Example 2 – Dividend received from associate

Group statement of profit or loss for the year-ended 31 December 2015 (extract)

	$m
Operating profit	83
Finance costs	(12)
Share of profit of associate	20
Profit before tax	91
Taxation	(31)
Profit for the year	60
Attributable to:	
Ordinary shareholders of the parent	54
Non-controlling interest	6

Group statement of financial position as at 31 December 2015 (extract)

	2015	*2014*
	$m	*$m*
Assets		
Non-current assets		
Investment in associate	190	180

Calculate the dividend received from associate to appear in the group statement of cash flows for the year-ended 31 December 2015.

5. Acquisition/disposal of subsidiary

The acquisition or disposal of a subsidiary during the year is shown as a net cash outflow or inflow within investing activities to show the net cash paid to acquire the subsidiary or net cash received on disposal of a subsidiary.

An indirect adjustment is also required to adjust for any other balances (e.g. PPE, inventory, receivables, and payables) consolidated as part of the acquisition or disposed of as part of the disposal.

Working capital movement

	Inventory	*Receivables*	*Payables*
Opening	X	X	X
Acquisition/(disposal)	X/(X)	X/(X)	X/(X)
Expected	X	X	X
Closing (actual)	X	X	X
Movement	↑or ↓	↑or ↓	↑ or ↓

Example 3 – Acquisition of a subsidiary

Pablo Group statement of financial position as at 31 December 2015 (extract)

	2015	*2014*
	$m	*$m*
Non-current assets		
Property, plant and equipment	520	490
Current assets		
Inventory	145	195
Receivables	130	109
Cash and cash equivalents	50	75
Current liabilities		
Trade payables	85	67

The following information relates to the financial statements of the Pablo Group:

On 1 June 2015, Pablo acquired all of the share capital of Juan for $50 million.

The fair value of the identifiable net assets and liabilities at the date of acquisition that have been reflected in the year-end balances of the Pablo Group are as follows:

	$m
Property, plant and equipment	15
Inventory	8
Receivables	6
Cash and cash equivalents	5
Payables	(3)

Show how the above would be dealt with in the consolidated statement of cash flows for the year-ended 31 December 2015.

Example 4 – Group statement of cash flows

The following draft group financial statements relate to Dove, a public limited company.

Dove Group statement of financial position as at 31 December 2015

	2015	*2014*
	$m	*$m*
Assets:		
Non-current assets		
Property, plant and equipment	1,745	1,250
Goodwill	1,184	1,230
Investment in associate	200	190
	3,129	2,670
Current assets:		
Inventory	530	580
Receivables	456	390
Cash and cash equivalents	190	230
	1,176	1,200
Total assets	4,305	3,870
Equity and liabilities:		
Share capital	1,700	1,500
Retained earning	1,060	900
	2,760	2,400
Non-controlling interest	575	540
	3,335	2,940
Non-current liabilities		
Long-term borrowings	300	200
Deferred tax	220	190
Current liabilities		
Trade payable	300	430
Current tax payable	150	110
	450	540
Total liabilities	970	930
Total equity and liabilities	4,305	3,870

Dove group statement of profit or loss for the year-ended 31 December 2015

	$m
Revenue	1,765
Cost of sales	(1,185)
Gross profit	580
Distribution costs	(100)
Administrative expenses	(90)
Profit before interest and tax	390
Finance costs	(55)
Share of profit of associate	40
Profit before tax	375
Taxation	(95)
Profit for the year	280

Dove group statement of changes in equity for the year-ended 31 December 2015

	Equity shares	*Retained earnings*		*NCI*	*Total*
	$m	*$m*		*$m*	*$m*
B/f	1,500	900	2,400	540	2,940
Issue of share capital	200		200		200
Dividends		(65)	(65)	(20)	(85)
Total comprehensive income for the year		225	225	55	280
Transfer to retained earnings					
C/f	1,700	1,060	2,760	575	3,335

The following information relates to the financial statements of the Dove Group:

- On 1 June 2015, Dove acquired all of the share capital of Fred for $50 million. The fair value of the identifiable net assets and liabilities at the date of acquisition that have been reflected in the year-end balances of the Dove Group are as follows:

	$m
Property, plant and equipment	13
Inventory	20
Receivables	15
Cash and cash equivalents	3
Payables	(9)
	42

Goodwill arising on this transaction was $8m.

- Dove owns 20% of an associate. The associate made a profit for the year of $200 million and paid a dividend of $150 million.
- During the year Dove charged depreciation of $130 million on its property, plant and equipment. It sold property, plant and equipment with a carrying value of $43million for $50 million

Calculate the following balances to be included in the Dove Group statement of cash flows for the year-ended 31 December 2015: (i) Cash generated from operations, (ii) Net cash paid to acquire the subsidiary, (iii) Dividend paid to the non-controlling interests, and (iv) Dividend received from the associate.

6. Other cash flow issues

Format

You will remember from your FR studies that there is an alternative format for cash flow statements known as the **Direct Method**. Companies using this method report operating cash flows in a different way:

Operating CF	
Receipts from customers	X
Payments to suppliers	(X)
etc	

Although it is unlikely that you would be asked to draft cash flow extracts using the direct method you should learn the following points:

1. The direct method is preferred by IAS 7 because it gives users information not readily otherwise available in the financial statements.

2. The direct method is not normally used by companies, because, to do so, would take extra time and create additional expense.

Pensions

Pensions should de dealt with as follows:

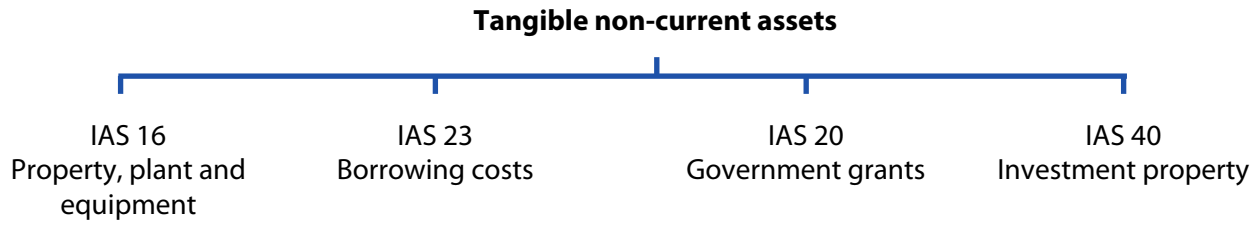
1. Add back **service costs** in **operating cash flows** as a non-cash-item (like depreciation).

2. Deduct **contributions paid** in **operating cash flows** as a cash outflow.

ACCOUNTING STANDARDS

Chapter 8

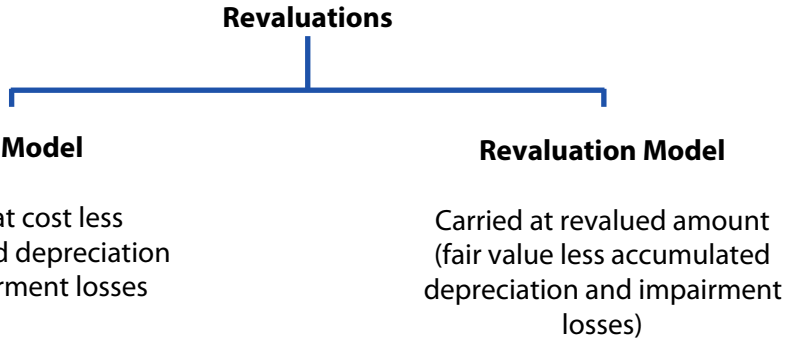
NON-CURRENT ASSETS



1. Property, plant and equipment (IAS 16)

Measurement at recognition

- At cost
  - Purchase price
  - Directly attributable costs in bringing asset to its location and condition
  - Costs to dismantle/restore (@ present value)



- Review periodically and keep revaluations up to date
- Consistent policy for each class of asset (avoids cherry-picking of assets)
- Revalue at open market value (i.e. value regardless of existing use)
- Depreciate the revalued asset less residual value over its remaining useful life

Example 1 – Revaluation increase

Panama bought an item of property, plant and equipment for $80 million on 1 January 2012. The asset had zero residual value and was to be depreciated over its estimated useful life of 20 years.

On 1 January 2015 the asset was revalued to its fair value of $95 million.

Calculate the amounts to shown in the financial statements of Panama for the year-ended 31 December 2015.

Example 2 – Revaluation decrease

On 1 January 2013, Panama purchased an item of property, plant and equipment for $12 million. Panama uses the revaluation model to value its non-current assets. The asset has zero residual value and is being depreciated over its estimated useful life of 10 years. At 31 December 2014, the asset was revalued to $14 million but at 31 December 2015, the value of the asset had fallen to $8 million. Panama has not taken the effect of the revaluation at 31 December 2015 in its financial statements.

Calculate the amounts to shown in the financial statements of Panama for the year-ended 31 December 2015.

Specialised assets do not have a fair value as no market value is readily available as they are very rarely sold. In order to revalue a specialised asset, we need to use a depreciated replacement cost valuation.

Illustration – depreciated replacement cost

Peru owned a specialised item of PPE that had cost $10 million. Its original useful life was 10 years and after 5 years when its carrying amount was $5 million the replacement cost of the asset was $15 million.

The depreciated replacement cost at this date is $7.5 million, as the asset is halfway through it useful life ($15 million x 5 /10), and the asset is revalued from $5 million to $7.5 million to give a revaluation surplus in the year of $2.5 million.

2. Depreciation

- Straight line
- Reducing balance

Depreciation starts when the asset is ready for its intended use and not from when it starts to be used.

Any change in estimate is applied prospectively by applying the new estimates to the carrying value of the PPE at the date of change.

Separate the cost into its component parts and depreciate separately if a complex asset.

Example 3 – Change in estimate

Ecuador bought an item of property, plant and equipment for $25 million on 1 January 2012 and depreciated over its useful life of 10 years.

On 31 December 2014, the assets remaining life was estimated as 5 years.

Calculate the amounts to shown in the financial statements of Ecuador for the year-ended 31 December 2015.

3. Borrowing costs (IAS 23)

Borrowing costs, net of income received from the investment of the money borrowed, on a qualifying asset must be capitalised over the period of construction.

Capitalisation starts when:

- Expenditure on the asset commences
- Borrowing costs are being incurred
- Activities necessary to prepare the asset are in progress

Capitalisation must stop when the asset is ready for its use (whether or not it is being used) or when there is no active construction.

Capitalisation for specific borrowings is capitalised using the **effective rate** of interest.

Example 4 – Specific borrowings

Columbia commenced the construction of an item of property, plant and equipment on 1 March 2015 and funded it with a $10 million loan. The rate of interest on the borrowings was 5%.

Due to a strike no construction took place between 1 October and 1 November.

Calculate the amount of interest to be capitalised as par to of non-current assets if Columbia's reporting date is 31 December 2015.

4. Government grants (IAS 20)

Recognise the grant when the:

- Entity will comply with the conditions attached to the grant
- Entity will actually receive the grant

Grants should be recognised according to the deferred income approach, using a systematic basis. This spreads the income over the period in which the related expenditure is recognised.

If the grant is used to buy depreciating assets, the grant must be spread over the same life and using the same method.

Example 5 – Grants and depreciable assets

Tweddle bought an item of property, plant and equipment for $10 million and received a government grant of $2 million. The PPE has a useful life of 10 years and has no residual value.

Explain how the purchase of the property, plant and equipment and government grant would be dealt with in the financial statements of Tweddle.

Note: If a government grant becomes repayable, it is treated as a change in accounting estimate.
The payment is first shown against any remaining deferred income balance.
If the payment exceeds the deferred income balance then the excess payment is treated as an expense.

5. Investment properties (IAS 40)

Investment property is property (land or a building – or part of a building – or both) held) to earn rentals or for capital appreciation or both, rather than for:

- Use in the production or supply of goods and services or for administrative purposes (IAS 16); or
- Sale in the ordinary course of business (IAS 2)

Initial measurement

Investment properties should initially be measured at cost plus directly attributable costs.

Subsequent measurement

Fair value model

- The investment properties are revalued to fair value at each reporting date
- Gains or losses on revaluation are recognised directly through profit or loss
- The properties are not depreciated

Cost model

- The investment properties are held using the benchmark method in IAS 16 (cost)
- The properties are depreciated like any other asset

Transfers into and out of investment property should only be made when supported by a change of use of the property.

- IP to owner occupied (IAS 16) – Fair value at date of change
- IP to inventory (IAS 2) – Fair value at date of transfer
- Owner occupied (IAS 16) to IP – Revalue under IAS 16 and then treat as IP
- Inventory (IAS 2) to IP – Fair value on change and gain/loss to profit or loss

Example 6– Investment property and change of use

Addlington owns a property that it is using as its head office. At 1 January 2015, its carrying value was $20 million and its remaining useful life was 20 years. On 1 July 2015 the business was reorganised cheaper premises were found for use as a head office. It was therefore decided to lease the property under an operating lease.

The property was valued by a qualified professional, who assessed the property's value as $21 million on 1 July and $21.6 million on 31 December 2015.

Explain the accounting treatment of the property in the financial statements for the year-ended 31 December 2015.

Initial classification

Be careful with what is and is not an investment property. In particular:

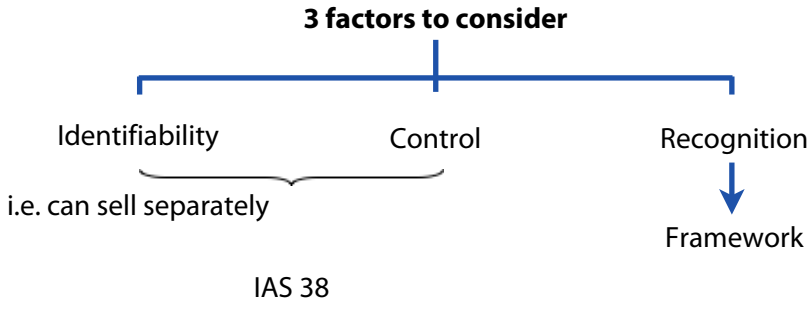
- Company owns property and lets it out at commercial rent – definitely **investment property**.
- Company builds property with a view to selling it – this would be **inventory**.
- Company owns property and uses it as hotel – this would be **PPE** (any services offered to tenants must be inconsequential if a building is classified as IP).
- Company owns property and rents it out under a finance lease – the relevant asset in the SFP will be a **lease receivable**.

Chapter 9

INTANGIBLE ASSETS (IAS 38)

No physical substance but has value to the business.

- patents
- brand names
- licences



Separate acquisition
Capitalise at cost plus any directly attributable costs (e.g. legal fees, testing costs). Amortisation is charged over the useful life of the asset, starting when it is available for use.

Research
Research expenditure is charged immediately to profit or loss in the year in which it is incurred.

Development
Development expenditure must be capitalised when it meets all the criteria.

- Sell/use
- Commercially viable
- Technically feasible
- Resources to complete
- Measure cost reliably (expense)
- Probable future economic benefits (overall)

Internally generated
Internally generate brands, mastheads cannot be capitalised as their cost cannot be separated from the overall cost of developing the business.

Example 1 – Intangibles

Booker is involved in developing new products and has spent $15 million on acquiring a patent to aid in this development. The initial investigative phase of the project cost an additional $6 million, whereby it was determined that the future feasibility of the product was guaranteed.

Subsequent expenditure incurred on the product was $8 million, of which $5 million was spent on the functioning prototype and the remainder on getting the product into a safe and saleable condition.

A further $1 million was spent on marketing and $0.5 million on training sales staff on how to demonstrate the use of the product.

At the reporting date the product had not yet been completed.

Explain how Booker should account for the expenditure in its financial statements.

Chapter 10

IMPAIRMENTS (IAS 36)

1. Identify possible impairments (external vs. internal)
2. Perform impairment review (if identified possible impairments)
3. Record the impairment

1. Indicators of Impairment

External sources

- A significant decline in the asset's market value more than expected by normal use or passage of time
- A significant adverse change in the technological, economic or legal environment

Internal sources

- Obsolescence or physical damage
- Significant changes, in the period or expected, in the way the asset is being used e.g. asset becoming idle, plans for early disposal or discontinuing/ restructuring the operation where the asset is used
- Evidence that asset's economic performance will be worse than expected
- Operating losses or net cash outflows for the asset
- Loss of key employee

2. Impairment review

An impairment review is required:

1. If there is an impairment indicator (above)
2. **Every year** if there is goodwill in the SFP
3. **Every year** if there is an intangible asset in the SFP which is not being amortised because its life is indefinite.

If the carrying value of the asset is greater than its recoverable amount, it is impaired and should be written down to its recoverable amount.

- **Recoverable amount** - the greater of fair value less cost to sell and value in use.
- **Fair value less costs to sell** - the amount receivable from the sale of the asset less the costs of disposal.
- **Value in use** - the present value of the future cash flows from the asset.

3. Record the impairment

Individual asset

The reduction in carrying value is taken through profit or loss unless related to a revalued asset, in which case it is taken to any revaluation surplus first.

Cash generating unit (CGU)

The business should divide its assets up into individual cash generating units (CGUs). These are segments of the business that generate income independently from other segments. For example, if a tuition company offers accountancy and nursing training, then accountancy and nursing would be viewed as separate CGUs.

Once the impairment loss has been calculated the assets must be written down in the following order:

1. Specific assets (e.g. if physically impaired)
2. Goodwill
3. Remaining non-current assets (pro-rata)

Reversal of impairment losses

If the circumstances that triggered an impairment loss (e.g. a global pandemic) cease to apply (e.g. on discovery of a vaccine), then the impairment loss can be reversed EXCEPT in respect of any goodwill that has been written down.

Example 1 – CGU impairment

Peter owned 100% of the equity share capital of Sharon, a wholly-owned subsidiary.

The assets at the reporting date of Sharon were as follows:

	$'000
Goodwill	2,400
Buildings	6,000
Plant and equipment	5,200
Other intangibles	2,000
Receivables and cash	1,400
	17,000

On the reporting date a fire within one of Sharon's buildings led to an impairment review being carried out.

The recoverable amount of the business was determined to be $9.8 million. The fire destroyed some plant and equipment with a carrying value of $1.2 million and there was no option but to scrap it.

The remaining plant was worth at least its carrying value.

The other intangibles consist of a licence to operate Sharon's plant and equipment. Following the scrapping of some of the plant and equipment a competitor offered to purchase the patent for $1.5 million.

The receivable and cash are both stated at their realisable value and do not require impairment.

Show how the impairment loss in Sharon is allocated amongst the assets.

Note: Within a group of companies where there are several subsidiaries, the individual CGUs (subsidiaries) are tested for impairment first, before the overall value of the business is tested.

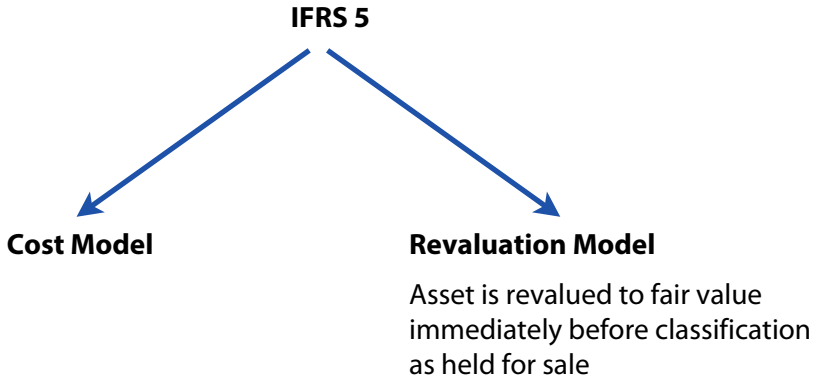
Chapter 11

NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS (IFRS 5)

1. Non-current assets held for sale

Must be available for immediate sale and sale must be highly probable (sell < 1 year, active programme to locate buyer, actively marketing).

Non-current asset held for sale is valued at the lower of the carrying value and fair value less costs to sell. Any reduction in value is recorded as an impairment through profit or loss.



- Once classified as a non-current asset held for sale it is no longer depreciated.
- The subsequent sale of the asset will give rise to a profit/loss on disposal.

Example 1 – NCA-HFS

At 1 January 2015, Namibia carried a property in its statement of financial position at its revalued amount of $14 million in accordance with IAS 16 Property, Plant and Equipment. Depreciation is charged at $300,000 per year on the straight line basis.

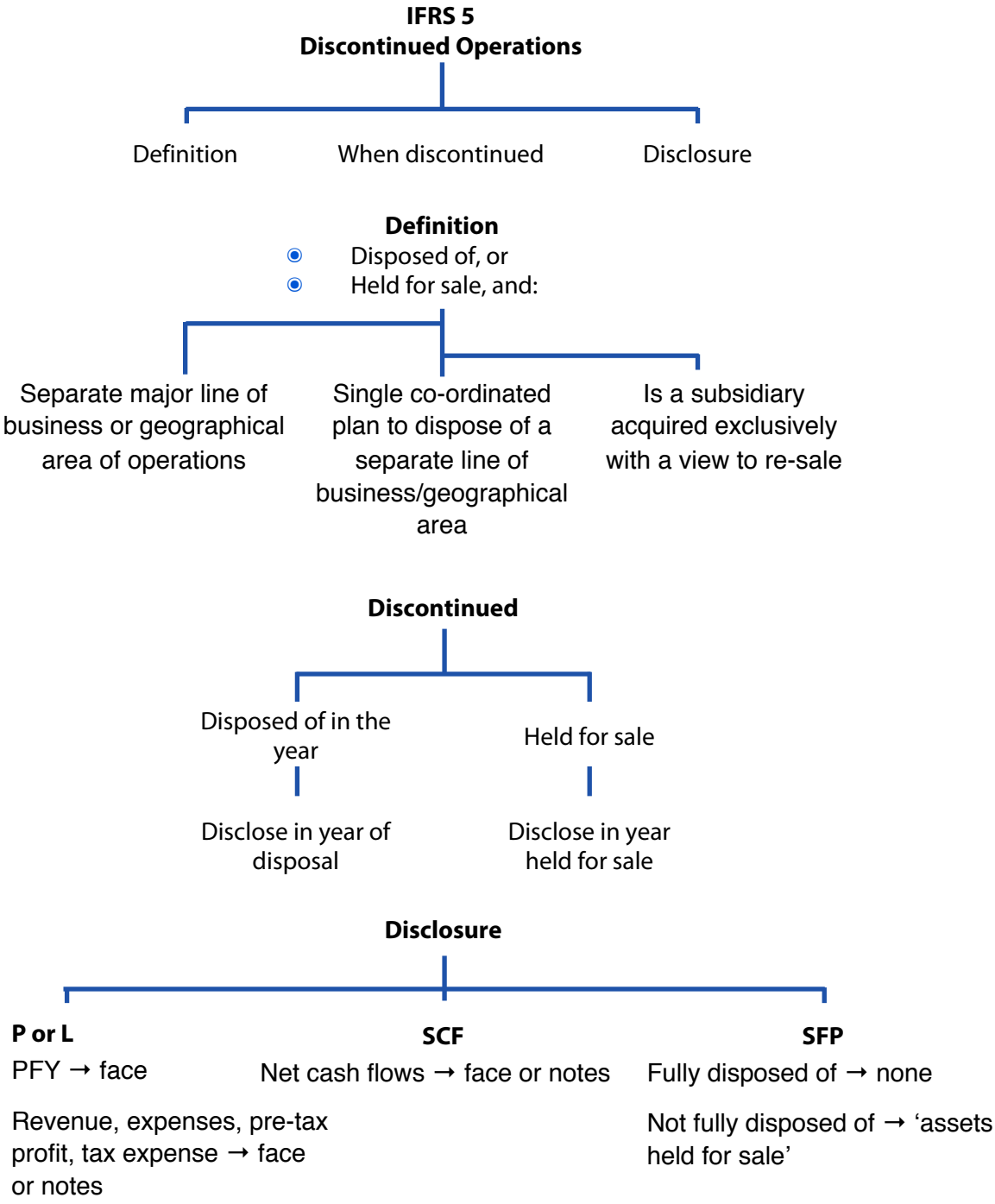
In April 2015, the management decided to sell the property and it was advertised for sale. By 30 April 2015, the sale was considered to be highly probable and the criteria for IFRS 5 Non-current Assets Held for Sale and Discontinued Operations were met at this date. At that date, the asset's fair value was $15·4 million. Costs to sell the asset were estimated at $300,000.

On 31 January 2016, the property was sold for $15.6 million.

The transactions regarding the property are deemed to be material and no entries have been made in the financial statements regarding this property since 31 December 2014.

Explain how the above transaction should be dealt with in the financial statements of Namibia for the year-ended 31 December 2015.

2. Discontinued operations



Example 2 – Discontinued operations

Angola's car manufacturing operation has been making substantial losses. Following a meeting of the board of directors, it was decided to close down the car manufacturing operation on 31 March 2016. The company's reporting date is 31 December and the car manufacturing operation is treated as a separate operating segment.

Explain how the decision to close the car manufacturing operation should be treated in Angola's financial statements for the years ending 31 December 2015 and 2016.

Chapter 12

EMPLOYEE BENEFITS (IAS 19)

1. Pensions

Jargon buster

1. When a company sets up a pension plan it will make **contributions** to the plan in line with the guidance of an **actuary.**

2. When the employees retire the plan will pay out **benefits** in accordance with the rules of the plan.

3. There are two types of plan: **defined contribution** and **defined benefit.**

4. In a **defined contribution** plan, the company promises a level of contribution (e.g. 5% of salary), but no guarantee is given of what benefits may ultimately be paid out by the plan. The employee takes all the risk.

5. In a **defined benefit** plan, the company promises a level of benefit (based on years of service and salary while in service). In this case the company faces uncertainty over the level of contributions that will be required to fund the benefits. Thus the company takes all the risk.

6. **Important**. You are not sitting an actuarial exam, so don't worry too much about the terminology. All that matters is that you recognise the term (e.g. service cost) and know where it should be shown in the financial statements.

Defined contribution scheme

Contributions are accrued in the financial statements with an expense recognised in profit or loss.

Defined benefit scheme

Statement of financial position (extract)

	$m
Fair value of scheme assets	X
Fair value of scheme liabilities	(X)
Net pension asset/(liability)	X/(X)

Statement of profit or loss and other comprehensive income (extract)

	$m
Profit or loss	
Operating costs	
Current service costs	(X)
Past service costs	(X)
Financing costs	
Interest expense	(X)
Return on investment	X
Other comprehensive income	
Re-measurement gain/(loss) (W)	X/(X)

Workings

Assets	*$m*	Liabilities	*$m*
Opening	X	Opening	X
Return on investment	X	Interest	X
Contributions paid in	X	Service costs	X
Benefits paid out	(X)	Benefits paid out	(X)
Expected	X	Expected	X
Re-measurement component (β)	X/(X)	Re-measurement component (β)	X/(X)
Closing (per actuary)	X	Closing (per actuary)	X

Example 1 – Defined benefit scheme

Finland operates a defined benefit pension scheme for all of its employees. The closing balances on the scheme assets and liabilities, at 31 December 2014, were $60 million and $64 million respectively.

Finland's actuary has provided the following information that has yet to be accounted for in the year-ended 31 December 2015.

	$m
Current service cost	9
Past service cost	8
Contributions paid in	5
Benefits paid out	6
Fair value of plan asset	66
Fair value of plan liabilities	75
Yield on high quality corporate bonds	5%

Calculate the amounts that will appear in the financial statements of Finland for the year-ended 31 December 2015.

Curtailment

A curtailment occurs when there are a significant number of employees who leave the scheme, commonly seen if there is a re-organisation of the business or change in scheme from defined benefit to defined contribution.

The asset and liability are re-measured to fair value and any change is taken to profit or loss.

Example 2 – Curtailment

Flannagan announces the re-organisation of its business, resulting in the loss of jobs within the business.

The fair value of the plan assets and liabilities, immediately before the re-organisation, were $48 million and $60 million respectively.

The plan assets do not change following the curtailment but the pension liabilities are measured at $55 million.

Explain the accounting treatment of the curtailment in the financial statements.

Asset ceiling

If a company has an overall pension asset on its statement of financial position then the asset can only be recognised up to the level of the asset ceiling. The asset ceiling is the present value of any future cash savings of not having to contribute to the scheme as it is in surplus. If the asset needs to be reduced to the asset ceiling limit then the reduction in the asset is shown as an expense in other comprehensive income.

Example 3 – Asset ceiling

Brannagan has a net pension asset in its statement of financial position of $30 million. It therefore anticipates that it will not have to pay its usual contributions into the scheme for the next few years. It is estimated that the present value of the future reduction in contributions will be $26 million.

Explain how the net pension asset will be treated in the financial statements.

2. Other employment benefits

Short-term benefits

An example of a short-term benefit is holiday pay. If an employee does not take all of their annual leave, then the employer may allow them to carry some days forward to the next year. In this case, the employee is working additional days in the current year and fewer days in the subsequent year.

The accruals concept would require that an extra wage expense should be charged in the current year, and a lower charge in the subsequent year. Thus the wage expense will match the work done.

The entry for this adjustment would be Dr Wage expense Cr Accrual.

Long-term benefits

Examples of long-term benefits are bonuses payable more than 12 months after the balance sheet date and long-term disability payments made to staff. The accounting is similar to defined benefit pension plans except that remeasurement differences are recognised in the profit and loss account (instead of other comprehensive income).

Chapter 13

SHARE BASED PAYMENTS (IFRS 2)

1. Equity Settled

If the fair value of goods/services is known then this should be used in order to value the option, if the fair value of the goods/services is not known then the fair value of the option at the grant date should be used to value the options.

The fair value should be taken to profit or loss over the vesting period on a straight line basis, based on the number of options expected to be exercised. The corresponding credit entry will be recorded in equity reserves.

Example 1 – Fair value equity settled (services)

Brie granted 10,000 equity settled share based payments to its 20 directors on 1 January 2015. The options vest on 31 December 2017. It is anticipated that none of the directors will leave over the three year period. The fair value of the option is as follows:

	$
1 January 2015	12.00
31 December 2015	13.50
31 December 2016	13.80
31 December 2017	14.20

Prepare the extracts to be shown in the statement of profit or loss and the statement of financial position for each of the three years ended 31 December 2015 to 31 December 2017.

Example 2 – Options expected to be exercised

On 1 January 2014, Edam granted 20,000 share options to each of its ten directors. The conditions attached to the share option scheme is that the directors must remain an employee of Edam for three years. The fair value of each equity settled share based payment at the grant date was $60.

At 31 December 2014, it was estimated that four directors would leave before the end of the three years.

At 31 December 2015, due to a downturn in the economy, it was estimated that one director would leave before the end of the three years.

Prepare the extracts to be shown in the statement of profit or loss and the statement of financial position for the year ended 31 December 2014 and 31 December 2015.

Example 3 – Fair value equity settled (goods)

Caerphilly purchased inventory at a cost of $10 million on 1 July 2015. The goods were sold in November 2015 for $14 million.

Caerphilly had cash flow problems during 2015 and negotiated with its supplier to exchange the goods for options on its shares. The shares had a market value of £11.5 million on 1 July 2015.

Explain how the transaction should be dealt with in the financial statements for the year-ended 31 December 2015.

2. Cash settled

If the fair value of goods/services is known then this should be used in order to value the option, if the fair value of the goods/services is not known then the fair value of the option should be reassessed at each reporting date and this value should be used to value the options.

The fair value should be taken to profit or loss over the vesting period based on the number of options expected to be exercised. However as there will be a cash payment, the credit entry is recorded as a liability.

Example 4 – Fair value cash settled

Gouda granted 10,000 cash settled share based payments to its 20 directors on 1 January 2015. The options vest on 31 December 2017. It is anticipated that none of the directors will leave over the three year period. The fair value of the option is as follows:

	$
1 January 2015	12.00
31 December 2015	13.50
31 December 2016	13.80
31 December 2017	14.20

Prepare the extracts to be shown in the statement of profit or loss and the statement of financial position for each of the three years ended 31 December 2015 to 31 December 2017.

Example 5 – Options expected to be exercised (cash settled)

On 1 January 2014, Cheddar granted 20,000 share appreciation rights to each of its ten directors. The conditions attached to the cash settled share based payment scheme is that the directors must remain an employee of Cheddar for three years. The fair value of each cash settled share based payment at the 31 December 2014 was $80 and at 31 December 2015 was $75.

At 31 December 2014, it was estimated that four directors would leave before the end of the three years.

At 31 December 2015, due to a downturn in the economy, it was estimated that two directors would leave before the end of the three years.

Prepare the extracts to be shown in the statement of profit or loss and the statement of financial position for the year ended 31 December 2014 and 31 December 2015.

3. Vesting conditions

Non-market based	*Market based*
◉ Conditions related to an employee having to remain with company for a fixed period or related to growth in profit or in earnings per share	◉ Conditions related to the market price of the company's shares
◉ Non- market based vesting conditions are taken into account at each reporting period.	◉ Market based vesting conditions are ignored for the purpose of estimating the number of options that will vest

Example 6 – Vesting conditions

Cheshire granted 5,000 share options to each of its five directors on 1 January 2015. The share options will vest on 31 December 2017 if the share price reaches $15. It is not anticipated that any of the directors will leave during the three years.

The fair value of each option was $12 at the grant date and the share price at 31 December 2015 was $13. Due to the fall in global stock markets at the start of 2016, it is not anticipated that the share price will rise above its current price for the foreseeable future.

Explain the accounting treatment in the financial statements for the year ended 31 December 2015.

Unusual situations

Employee has a choice as to receiving shares or cash

A form of split accounting is used (similar to a convertible loan) where part of the cost is credited to liability with the balance being credited to equity.

Relevant examiner articles on the ACCA (students) website:
IFRS 2 – Share based payment

Chapter 14

FINANCIAL INSTRUMENTS (IAS 32, IFRS 7 AND IFRS 9)

Company A		*Company B*
Financial asset		**Financial liability, or equity**
Purchase shares in co. B	→	Issues shares
Purchase co. B debt	→	Issues debt
Sells goods to B	→	Buys good from A

Key definitions (abbreviated)

Financial asset Equity investment in another company OR contractual right to receive cash.

Financial liability Contractual obligation to deliver cash

Equity Residual interest in assets after deduction of liabilities

Derivative

1. Value linked to underlying asset
2. Requires little or no initial investment
3. Settled (for cash) at a future date

Note that commodity derivates (e.g. oil) settled by the delivery of the physical commodity are outside the scope of IFRS 9. These are known as executory contracts.

1. Financial assets

Initial measurement

Initially recognise at fair value plus transaction costs, unless classified as fair value through profit or loss where transaction costs are immediately recognised through profit or loss.

Subsequent measurement

- **Equity instruments**

  Fair value through profit or loss (default)

  Re-measure to fair value at the reporting date, with gains or losses through profit or loss.

  Fair value through other comprehensive income

  If there is a strategic intent to hold the asset for the long term, then the option to hold at fair value through other comprehensive income is available. Re-measure to fair value at reporting date, with gains or losses through other comprehensive income.

  Note that any decision to hold shares as FVOCI requires an IRREVOCABLE election – i.e. the company cannot later change its mind.

- **Debt instruments**

  Amortised cost

  A financial asset is measured at amortised cost if it fulfils both of the following tests:

  - Business model test – intent to hold the asset until its maturity date; and,
  - Contractual cash flow test – contractual cash receipts on holding the asset.

  If the contractual cash flow test is satisfied but there is no intention to hold the asset until maturity then the financial asset is held as **fair value through other comprehensive income**.

  Debt instruments may be reclassified if the entity changes its business model.

Derecognition

Financial assets are derecognised on transfer of risks and rewards to another party.When financial assets are sold, any gain or loss is treated as follows:

1. Equities held at FVPL – gain or loss to P&L.

2. Equities held at FVOCI – gain or loss to OCI (but transaction costs are charged in P&L).

3. Debt instruments held at FVOCI:

   - Step 1 – gain or loss to OCI
   - Step 2 – cumulative gains or losses recycled from OCI to P&L

Example 1 – Financial assets

Norman has the following financial assets during the financial year.

- Norman bought 100,000 shares in a listed entity on 1 November 2015. Each share cost $5 to purchase and a fee of $0.25 per share was paid as commission to a broker. The fair value of each share at 31 December 2015 was $3.50.
- Norman bought 200,000 shares in a listed entity on 1 March 2015 for $500,000, incurring transaction costs of £40,000. Norman acquired the shares as part of a long term strategy to realise the gains in the future. The fair value of the shares was £620,000 at 31 December.The shares were subsequently sold for $650,000 on 31 January 2016.
- Norman bought 10,000 debentures at a 2% discount on the par value of $100. The debentures are redeemable in four years' time at a premium of 5%. The coupon rate attached to the debentures is 4%. The effective rate of interest on the debenture is 5.71%.

Explain how each of the above financial assets will be accounted for in the financial statements.

2. Financial liabilities

Initial measurement

Initially recognise at fair value net of transaction costs ('net proceeds')

Subsequent measurement

- Amortised cost
- Fair value though profit or loss

  - this is rare but might be used to prevent an 'accounting mismatch'. For example, if the company borrows money to buy an investment property, it would make sense to value both the investment property and the loan liability at fair value - with changes being recognised in the profit and loss account.

Derecognition

- Financial liabilities are derecognised when they have been paid in full or transferred to another party.

Example 2 – Financial liabilities

Norma issues 20,000 redeemable debentures at their $100 par value, incurring issue costs of $100,000. The debentures are redeemable at a 5% premium in 4 years' time and carry a coupon rate of 2%. The effective rate on the debenture is 4.58%.

Calculate the amounts to be shown in the statement of financial position and statement of profit or loss for each of the four years of the debenture.

Modifications

What happens if the company refinances a debt (e.g. agrees a change of terms with the lender)? If the new liability is substantially different to the old liability, then the original liability is regarded as extinguished, and a new liability will be recognised. Any difference will be charged or credited in the profit and loss account.

3. Convertible debentures

If a convertible instrument is issued, the economic substance is a combination of equity and liability and is accounted for using split equity accounting.

The liability element is calculated by discounting back the maximum possible amount of cash that will be repaid assuming that the conversion doesn't take place. The discount rate to be used is that of the interest rate on similar debt without a conversion option.

The equity element is the difference between the proceeds on issue and the initial liability element.

The liability element is subsequently measured at amortised cost, using the interest rate on similar debt without the conversion option as the effective rate. The equity element is not subsequently changed.

Issue costs associated with the issue are recognised by adjusting the effective rate of interest on the debenture.

Example 3 – Convertible debentures

Alice issued one million 4% convertible debentures at the start of the accounting year at par value of $100 million, incurring issue costs of $1 million.

The rate of interest on similar debt without the conversion option is 6%.

The impact of the issue costs increases the effective rate of interest on the debt to 6.34%

Explain how Alice should account for the convertible debenture in its financial statements for each of the three years.

4. Derivatives

Derivative financial instruments should be recognised as either assets (favourable) or liabilities (unfavourable). They should be measured at fair value both upon initial recognition and subsequently, with any gains or losses through profit or loss.

You will be given the FV of a derivative in the exam. In general terms:

1. Options start out as a financial asset (premium paid). At the SFP date they will still be a financial asset.

2. Other derivatives (e.g. futures, swaps) start out with $nil value. At the SFP date they will either be a financial asset or a financial liability.

Illustration

Amy has taken out a $10 million, 5-year, variable rate loan but is concerned that interest rates are going to rise in the next year or so. Amy has been advised to enter into an interest rate swap with a counter party which requires Amy to pay a fixed rate of 3% and receive a variable rate of LIBOR.

Amy pays or receives a net cash amount each year based on the difference between the 3% and LIBOR.

The interest rate swap is a derivative because:

- There is no initial net investment
- Settlement occurs at yearly intervals
- The underlying variable, LIBOR, changes with time

5. Impairment of financial assets

Impairment rules under IFRS 9 apply to investments in debt (loan assets) that are held at amortised cost or at fair value through other comprehensive income.

An expected credit loss model is used in an attempt to recognise credit losses before default occurs, and it uses a three stage model to recognise the loss incurred.

	Expectations of credit losses	*Credit losses recognised*
Stage 1	Initial recognition and when no subsequent, significant deterioration in credit quality	PV of expected credit losses 12 months after reporting date (12 months expected credit losses)
Stage 2	Significant deterioration in credit quality	Impairment recognised at PV of expected credit shortfalls (Lifetime expected credit losses)
Stage 3*	Objective evidence of an impairment	

*The effective interest rate is applied to the carrying amount of the asset, net of any allowance, if there has been objective evidence of an impairment.

Illustration – Recognition of Stage 1 credit losses

On initial recognition the investor is required to assess the 12-month credit losses on its investments in debt. The credit loss is the difference between the cash received under the terms of the contract, and the cash expected to be received, discounted to present value.

Once the credit losses have been calculated, the 12-month expected credit losses are recognised, which are the lifetime credit losses multiplied by the probability of the issuer defaulting in the next 12-months.

If the lifetime expected credit losses are calculated as $200,000, using a 5% discount factor, and the probability of default is estimated as being 2% in the next 12-months, then the 12-month expected credit losses are $4,000 ($200,000 x 2%). The $4,000 is recorded within an allowance account and net against the value of the debt investment.

At the end of the first year, the 12-month expected credit loss is unwound. A year's worth of finance cost is recognised through profit or loss of $200 ($4,000 x 5%), alongside a corresponding increase in the loss allowance to $4,200 ($4,000 + $200). The loss allowance continues to be net against the value of the debt investment.

Illustration – Recognition of Stage 2 credit losses

The credit losses are re-assessed if there is a significant change in the credit risk of the investment and this leads to the 12-month expected credit losses being updated to reflect the lifetime expected credit losses. Using the figures from the previous illustration, we would recognise the full $200,000 lifetime expected credit losses.

Significant changes in credit risk is assumed if the cash receipt due is more than 30 days past its due date.

Illustration – Recognition of Stage 3 credit losses

Stage 3 occurs when there is objective evidence of an impairment, and the lifetime expected credit losses. The same lifetime expected credit losses would be applied as in the previous illustration, but the effective rate of interest on the investment would be applied to the net value of the debt investment, i.e. the figure after the deduction of the lifetime expected credit losses.

Trade receivables

It would place too much of a burden on companies to use the three-stage model for trade receivables. Therefore, prospective bad debts should ALWAYS be recognised in an allowance account based on LIFETIME EXPECTED CREDIT LOSSES.

Allowance account

You should note above that we have referred to 'allowances' not 'provisions'. It is very important that you only use the word 'provision' in connection with liability accounting, which is clearly not the case here.

Purchase of credit-impaired financial asset

If a company (probably a bank) takes over a debt of $10 million of which $1 million is not expected to be recovered, then the asset will be recognised with an initial carrying amount of $9 million.

6. Hedging (IAS 39)

Companies have items on their statement of financial position that may change in value or may have highly likely future cash flows that may fluctuate. The changes in the value of these items give rise to additional risk in the business. Financial managers may therefore adopt a process of hedging to manage this risk.

- Hedged item – Exposed asset, liability or future cash flow
- Hedging instrument – Derivative designed to protect against fluctuations in value
- Hedged risk – Specific risk being hedged against (IFRS 7)

The hedge accounting treatment of the hedged item and hedging instrument depends on the type o hedge.

Fair value hedge

A fair value hedge aims to protect the fair value of an item already recognised in the financial statements. It usually addresses the fear that the value of the asset might fall whilst it is being held within the business.

- Gain or loss on the instrument is recognised through profit or loss
- Gain or loss on the hedged item also recognised through profit or loss

Cash flow hedge

A cash flow hedge aims to protect the value of a highly probable future cash flow. It usually addresses the fear that the asset may rise in value before it is bought by the business.

- Gains / losses on effective portion of the instrument is recognised in other comprehensive income (OCI)
- Gain or loss on ineffective portion recognised through profit or loss
- Gain or loss on effective portion reclassified through profit or loss when the item is recognised.

Hedge Accounting Criteria

Hedge accounting is permitted under certain circumstances provided that all the following conditions are met:

- Formally designated and documented (including the entity's risk management objective and strategy for undertaking the hedge, identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the entity will assess the hedging instrument's effectiveness)
- The hedging relationship consists of eligible hedging instruments and eligible hedged items
- The hedge is effective through an economic relationship between the item and instrument, the effect of credit risk does not dominate the changes in value, designated hedge ratio is consistent with risk management strategy.

Hedge effectiveness (Cash Flow Hedges only)

The changes in the value of the item may not match up exactly to the changes in the value of the instrument. This gives rise to an ineffectiveness in the hedge.

- 'Over-hedge' – change in instrument > change in item, and ineffectiveness in the hedge and the gain/ loss recognised through other comprehensive income is equivalent to the change in the item (lower)
- 'Under-hedge' – change in instrument < change in item, and no ineffectiveness in the hedge and the gain/loss recognised through other comprehensive income is equivalent to the change in the instrument (lower)

Illustration – Hedge effectiveness (over hedge)

If the gain on the hedging instrument is $0.5 million and the loss on the hedged item is $0.4 million then we have an over hedge as the change in instrument > change in item.

The ineffectiveness is accounted for as follows:

- $0.4 million gain recognised through other comprehensive income, equivalent to the change in the item (lower)
- $0.1 million ineffective portion of the gain recognised through profit or loss

Illustration – Hedge effectiveness (under hedge)

If the gain on the hedging instrument is $0.8 million and the loss on the hedged item is $1.0 million then we have an under hedge as the change in instrument < change in item.

- The $0.8 million gain recognised through other comprehensive income is equivalent to the change in the instrument (lower)
- No ineffective portion on the instrument as 'under-hedge'

7. Disclosure (IFRS 7)

Financial instruments, particularly derivatives, often require little initial investment, though may result in substantial losses or gains and as such stakeholders need to be informed of their existence. The objective of IFRS7 is to allow users of the accounts to evaluate:

- The significance of the financial instruments for the entity's financial position and performance
- The nature and extent of risks arising from financial instruments
- The management of the risks arising from financial instruments

Nature and extent of financial risks

Financial risk arising from the use of financial instruments can be defined as:

- Credit risk
- Liquidity risk
- Market risk

Disclosures with regards to these risks need to be both **qualitative** and **quantitative**.

Relevant examiner articles on the ACCA (students) website:

Concepts of profit or loss and other comprehensive income

IFRS 9 Financial Instruments

Impairment of financial assets

IFRS 13 Fair value measurement

When does debt seem to be equity?

Chapter 15

FAIR VALUE (IFRS 13)

IASB has adopted a fair value method to measure assets and liabilities in its IFRS accounting standards because the historic cost convention was not consistent with the underlying qualitative characteristic of relevance.

The issue was the there was no definition of what fair value actually was, until IFRS 13 was created.

Fair value – The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The price should not be adjusted for transaction costs, but it is adjusted for transport costs."

IFRS 13 adopts a hierarchical approach to measuring fair value, whilst giving consideration to the principal market, being the largest market in which an asset/liability is traded. It also considers the highest and best use of an asset and if no principal market exists then we consider the most advantageous market.

Illustration – Markets

Roy is a UK company and sells fruit and vegetables to both retailers and manufacturers, but also sells produce overseas.

The following data relates to the produce that is sold:

	Sales to retailers	*Sales to manufacturers*	*Export sales*
Annual sales volume	7,000 tonnes	5,000 tonnes	3,000 tonnes
Price per tonne	$650	$500	$800

The principal market is the sales to retailers market as it has the greatest volume, whilst the export sales market is the most advantageous as it maximises the amount from selling the produce.

Level 1 inputs

Level 1 inputs are quoted prices in active markets (frequency and volume) for identical assets or liabilities that the entity can access at the measurement date.

A quoted market price in an active market provides the most reliable evidence of fair value and is used without adjustment to measure fair value whenever available, with limited exceptions.

Level 2 inputs

Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 2 inputs include:

- quoted prices for similar assets or liabilities in active markets
- quoted prices for identical or similar assets or liabilities in markets that are not active
- inputs other than quoted prices that are observable for the asset or liability, for example interest rates and yield curves observable at commonly quoted intervals

Level 3 inputs

Level 3 inputs are unobservable inputs for the asset or liability and covers the scenarios whereby there is little, if any, market activity.

An entity develops unobservable inputs using the best information available in the circumstances, which might include the entity's own data, taking into account all information about market participant assumptions that is reasonably available.

Chapter 16

OPERATING SEGMENTS (IFRS 8)

IFRS 8 Operating segments aims to assist users to:

- Understand past performance
- Understand the risk and returns of each segment
- Make better informed judgements

An operating segment is one whose results are regularly reviewed by the **chief operating decision maker** (CODM), thus giving the users of the accounts an internal view of the company and how the results are reviewed.

Disclosure

An operating segments results must be disclosed if:

- Segment revenue is greater than or equal to 10% of the total revenue (internal and external)
- Segment result is greater than or equal to 10% of greater of:
  - Total profits of all segments in profit, and
  - Total losses of all segments in loss.
- Segment assets are greater than or equal to 10% of total assets

If the total reportable segment revenue does not make up at least 75% of external revenue then additional segment will need to be disclosed.

Two or more operating segments may be combined if they have similar economic characteristics with regards to the following:

- The nature of the products or services
- The nature of the production process
- The type or class of customer
- The methods used to distribute the products/services
- The nature of the regulatory environment

Each reportable segment should then decide what to disclose.

- Segment revenue
- Segment results – note that disclosure of this figure is compulsory
- Segment assets
- Segment liabilities
- Capital expenditure
- Depreciation/amortisation
- Other non-cash expenses

General disclosures are:

- How the operating segments have been identified
- The products and services that the group provides
- Reliance on major customers
- Geographical information (limited to revenue and non-current assets)

Example 1 – Operating segments

Gulf is preparing is operating segment disclosure note for the first time following its listing on the local stock exchange during the year. Its chief operating decision maker (CODM) regularly reviews the results of its three separate divisions:

- Domestic railway operations
- International railway operations
- Railway construction

Gulf is intending to report two operating segments in its disclosure note as opposed to the three reviewed by the CODM. The domestic and international operations are to be combined because it is felt that they have similar economic characteristics due to the services that they offer.

The domestic operations involve a competitive tender process to run the railway service, which is then awarded by the local transport authority. The local transport authority then sets the ticket prices and collects the fares which are then distributed amongst the various operators running the contracts.

The international operations' ticket prices are set by Gulf, who collects the fares from the passengers directly.

Advise Gulf as to whether the proposed combination of the two operating segments is appropriate.

Chapter 17

REVENUE FROM CONTRACTS WITH CUSTOMERS (IFRS 15)

IFRS 15 has replaced the previous IFRS on revenue recognition, IAS 18 Revenue and IAS 11 Construction Contracts. It uses a principles-based 5-step approach to apply to contact with customers.

The five steps are as follows:

1. Identification of contracts
2. Identification of performance obligations (goods, services or a bundle of goods and services)
3. Determination of transaction price
4. Allocation of the price to performance obligations
5. Recognition of revenue when/as performance obligations are satisfied

1. Identification of contracts

The contract does not have to be a written one, it can be verbal or implied. In order for IFRS 15 to apply the following must all be met:

- The contract is approved by all parties
- The rights and payment terms can be identified
- The contract has commercial substance
- It is probable that revenue will be collected

2. Identification of performance obligations

If the goods or services that have agreed to be exchanged under the contract are distinct (i.e. could be sold alone) then they should be accounted for separately.

If a series of goods or services are substantially the same they are treated as a single performance obligation.

Illustration – Performance obligations

LiverTech is a computer business that primarily sells computer hardware. As well as selling computers, it also supplies and installs the software to its customers and provides a technical support package over a number of years. The business commonly sells the supply and installation, and technical support in a combined goods and services contract.

The combined goods and services contract has two separate performance obligations, which would need to be separated out and recognised separately.

The installation of software would be recognised once complete and the provision of technical services over the period of the support service.

3. Determination of transaction price

The amount the selling party expects to receive is the transaction price.

This should consider the following:

- Significant financing components
- Variable consideration
- Refunds and rebates (paid to the customer!)

Example 1 – Transaction price

Luckers Co. sells a car to a customer for $10,000, offering interest-free credit for a three-year period. The car is delivered to the customer immediately. The annual market rate of interest on the provision of consumer credit to similar customers is 5%.

What is the transaction price?

4. Allocation of the price

The price is allocated proportionately to the separate performance obligations based upon the stand-alone selling price.

Example 2 – Allocation of price

Richer Co. sells home entertainment systems including a two-year repair and maintenance package for $10,000. The price of a home entertainment system without the repair and maintenance contract is $9,000 and the price to renew a two-year maintenance package is $2,000.

How is the $10,000 contract price allocated to the separate performance obligations?
Note: Ignore any discounting and time value of money.

5. Recognition of revenue

Once control of goods or services transfers to the customer, the performance obligation is satisfied and revenue is recognised. This may occur at a single point in time, or over a period of time.

If a performance obligation is satisfied at a single point in time, we should consider the following in assessing the transfer of control:

- Present right to payment for the asset
- Transferred legal title to the asset
- Transferred physical possession of the asset
- Transferred the risks and rewards of ownership to the customer
- Customer has accepted the asset.

Example 3 – IFRS 15 (1)

Telephonica sells mobile phones, selling them for "free" when a customer signs up for a 12 month contract. The contract costs the customer $45 per month.

Explain how the revenue should be recognised in Telephonica's financial statements
Note: A competitor sells mobile phones without a monthly contract, selling the handset for $480. Call and data charges are $20 per month. Ignore discounting and the time value of money

Example 4 – IFRS 15 (2)

LiverTech is a computer business that primarily sells computer hardware. As well as selling computers, it also supplies and installs the software to its customers and provides a technical support package over two years. The business commonly sells the supply and installation, and technical support in a combined goods and services contract.

The combined goods and services contract sells for $1,600, but if sold separately the supply and installation is sold for $1,500 and the technical support for $500.

If LiverTech sold a combined contract on 1 July 20X7, demonstrate how the transaction would be presented in the financial statements for the year ended 31 December 20X7.

If a performance obligation is transferred over time, the completion of the performance obligation is measured using either of the following methods:

- Output method – revenue is recognised based upon the value to the customer, i.e. work certified.

$$\text{Output method} = \frac{\text{Work certified to date}}{\text{Total contract revenue}}$$

- Input method – revenue is recognised based upon the amounts the entity has used, i.e. costs incurred or labour hours.

$$\text{Input method (cost based)} = \frac{\text{Costs to date}}{\text{Total estimated costs}}$$

Example 5 – Performance obligations over time and the statement of profit or loss (1)

Alex commenced a three year building contract during the year-ended 31 December 20X4 and continued the contract during 20X5. The details of the contract are as follows:

	$m
Total contract value	45
Costs incurred to date @ 20X5	20
Estimated costs to completion	12

Show how this contract would be dealt with in the statement of profit or loss for the year ended 31 December 20X5.

6. Specifics

Principal vs agent - When a third party is involved in providing goods or services to a customer, the seller is required to determine whether the nature of its promise is a performance obligation to:

- Provide the specified goods or services itself (principal) or
- Arrange for a third party to provide those goods or services (agent)

In an AGENCY situation, the company will recognise commission received and receivable as revenue.

Repurchase agreements - When a vendor sells an asset to a customer and is either required, or has an option, to repurchase the asset. The legal form here is always a sale followed by a purchase at a later date. The economic substance is more likely to be a loan secured against an asset that is never actually being sold.

Consignments – arises where a vendor delivers a product to another party, such as a dealer or retailer, for sale to end customers. The inventory is recognised in the books of the entity that bears the significant risk and reward of ownership (e.g. risk of damage, obsolescence, lack of demand for vehicles, no opportunity to return them, the showroom-owner must buy within a specified time if not sold to public)

Contract modifications - what happens if a contract is changed so that one party agrees to do something extra for the other party in return for extra consideration? If the extra consideration reflects the normal selling price ('stand-alone selling price') of the additional service, then the modification will be seen as a separate contract with a separate performance obligation. Therefore, there will be no change to the accounting for the original contract.

Sale with a right of return - if a store sells goods and the customer has the right to return the goods within 30 days if they change their mind about the purchase, should the sale be recognised? The store will have to assess the likelihood of the goods being returned. If a return is likely, no revenue should be recognised. Instead the sale proceeds would be credited to the contract liability account. At the year end the business would recognise an asset - being the right to recover the inventory from the customer - this is the equivalent to recognising closing inventory: Dr Asset (right to recover) Cr Cost of sales.

Non-refundable up-front fees - if you join a gym you are sometimes asked to pay a joining fee of, say, $50. Is this a separate performance obligation? Is the gym doing something extra for you on the joining day? The facts of every case are different - however, this is probably just another way of extorting money from the customer! In many cases the up-front fee would not be a separate performance obligation, and it would therefore be credited to the contract liability account.

Warranties - if you buy a car with a 1 year warranty (seller to repair the car if it breaks down), would this be a separate performance obligation? Probably not - in most cases the buyer has no choice about the warranty; the seller will not offer a discount with no warranty! Therefore, the seller would recognise the total sale proceeds on the date of transfer of control of the car. However, the seller would also recognise a provision for expected repair costs.

Sometimes sellers do offer an optional extended warranty (for an extra 2 years). As this is a distinct service it would be seen as a separate performance obligation, with revenue being recognised over the term of the extended warranty.

Relevant examiner articles on the ACCA (students) website:

Revenue revisited

Chapter 18

LEASES (IFRS 16)

IFRS 16 Leases is to be adopted for accounting periods starting on or after 1 January 2019. It can be adopted earlier but only if the entity has already adopted IFRS 15 Revenue from contracts with customers.

The new standard on leases is replacing the old standard (IAS 17) where the existence of operating leases meant that significant amounts of finance were held off the balance sheet. In adopting the new standard all leases will now be brought on to the statement of financial position, except in the following circumstances:

- leases with a lease term of 12 months or less and containing no purchase options – this election is made by class of underlying asset; and
- leases where the underlying asset has a low value when new (such as personal computers or small items of office furniture) – this election can be made on a lease-by-lease basis. Low value is less than $5,000.

The accounting for low value or short-term leases is done through expensing the rental through profit or loss on a straight-line basis.

Example 1 – Low-value assets

Banana leases out a machine to Mango under a four year lease and Mango elects to apply the low-value exemption.

The terms of the lease are that the annual lease rentals are $2,000 payable in arrears. As an incentive, Banana grants Mango a rent-free period in the first year.

Explain how Mango would account for the lease in the financial statements.

1. Identifying a lease

A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration [IFRS16:9]

Control is conveyed where the customer has both the right to direct the identified asset's use and to obtain substantially all the economic benefits from that use. [IFRS 16:B9] However, if the supplier has a substantive right to substitute the asset during the period of use then the customer does not have the right of use of the asset and hence there is no lease.

Example 2 – Identifying a lease

For each of the two following scenarios explain if the contract is a lease or if it contains a lease.

1. Peach needs to transport its goods to customers in Europe using rail freight. The company enters into a contract with a rail freight carrier for the use of 10 rail cars of a particular type for five years.
2. Peach needs to transport its goods to customers in Europe using rail freight. The company enters into a contract with a rail freight carrier that requires the carrier to transport a specified quantity of goods by using a specified type of rail car in accordance with a stated timetable for five years

2. Lease and non-lease components

A combined contract where part of the payment is for the lease of the asset and part of the payment is for the provision of additional services by the lessor (e.g. maintenance) then the lessee needs to spit the rental into a lease component and non-lease component. The payment by the lessee is to be allocated based on the stand-alone prices of the components.

Example 3 – Lease and non-lease components

Pear enters into a contract for the use of an item of machinery and its annual maintenance for a combined total of $100,000 per annum, payable at the end of the lease period.

The rental of the machinery without any maintenance is $95,000 per annum, whilst a stand-alone maintenance contract is $10,000 per annum.

Explain how the annual rental should be split between the lease and non-lease component.

3. Lessee accounting

Initial recognition

At the start of the lease the lessee initially recognises a right-of-use asset and a lease liability. [IFRS 16:22]

Right of use asset

Measured at the amount of the lease liability plus any initial direct costs incurred by the lessee.

- Lease liability
- Initial direct costs
- Estimated costs for dismantling
- Payments less incentives before commencement date

Lease liability

Measured at the present value of the lease payments payable over the lease term, discounted at the rate implicit in the lease

- Fixed payments less incentives
- Variable payments (e.g. CPI/rate)
- Expected residual value guarantee
- Penalty for terminating (if reasonably certain)
- Exercise price of purchase option (if reasonably certain)

Note: if the rate implicit in the lease cannot be determined the lessee shall use their incremental borrowing rate

Subsequent measurement

Right of use asset

Cost less accumulated depreciation

Note: Depreciation is based on the earlier of the useful life and lease term, unless ownership transfers, in which case use the useful life.

Lease liability

Financial liability at amortised cost

Variable lease payments

If lease payments are, for example, linked to a price index, then the lease liability will change. There will be a corresponding change in the carrying amount of the right-of use asset.

So, if the lease liability increases by $1 million, the adjustment will be Dr Right-of-use asset Cr Lease liability with $1 million.

Example 4 – Lessee accounting

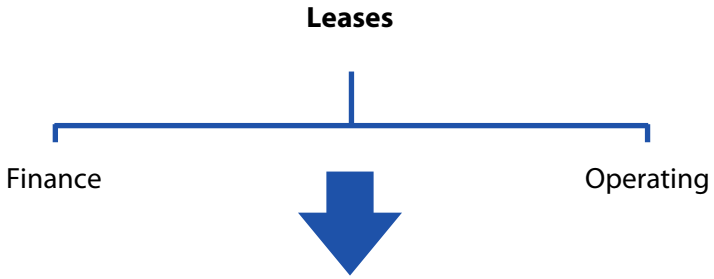
On 1 January 2015, Plum entered into a five year finance lease of machinery. The machinery has a useful life of six years. The annual lease payments are $5,000 per annum, with the first payment made on 1 January 2015. To obtain the lease Plum incurs initial direct costs of $1,000 in relation to the arrangement of the lease but the lessor agrees to reimburse Plum $500 towards the costs of the lease.

The rate implicit in the lease is 5%. The present value of the minimum lease payments is $22,730.

Demonstrate how the lease will be accounted in the financial statements over the five year period.

4. Lessor accounting

Classification of the lease



Finance lease if risks and rewards of ownership transferred to lessee.

- Ownership passes at end of the lease term
- Option to purchase asset at below fair value at end of lease and reasonably certain option will be exercised
- Lease term represents the major part of assets economic life
- PV of minimum lease payments represents substantially all of the asset's fair value
- Leased asset is specialised in nature

Operating lease accounting

Operating lease income receipts are recognised as income through profit or loss on a straight line basis.

Depreciation on the asset continues over its useful life.

Example 5 – Operating leases

Banana leases out a machine to Mango under a four year operating lease. The terms of the lease are that the annual lease rentals are $2,000 payable in arrears. As an incentive, Banana grants Mango a rent free period in the first year.

Explain how both Banana would account for the lease in the financial statements.

Finance lease accounting

1. Derecognise asset and record a receivable (@ net investment in the lease")
2. Record finance lease receipts as a reduction in the receivable
3. Record interest income on the receivable

Net investment in the lease = Gross investment in the lease discounted at the implicit rate of interest

Gross investment in the lease = Minimum lease payments receivable plus any unguaranteed residual value

Example 6 – Finance lease

Cherry leases out an item of property, plant and equipment under a 5 year finance lease. The lease commenced on 1 January 2015 and the rate implicit in the lease is 4%. The annual lease rentals of $5,000 are paid at the start of the lease period.

Cherry estimates that the unguaranteed residual value of the PPE is $400.

Calculate Cherry's net investment in the lease.

5. Sale and leaseback

A sale and leaseback transaction occurs when one entity (seller) transfers PPE to another entity (buyer) who then leases the asset back to the original seller (lessee).

The companies are required to account for the transfer contract and the lease applying IFRS 16, however consideration is first given to whether the initial sale of the transferred asset is a sale under IFRS 15.

If the lease term is similar to the asset life, it is likely that the transaction is NOT a sale. It is in substance a loan secured on the PPE - as when you might raise a loan from a bank.

If the transfer of the asset is not a sale then the following rules apply:

Seller-Lessee

- Continue to recognise the PPE
- Recognise a financial liability (= proceeds)

Buyer-Lessor

- Do not recognise the PPE
- Recognise a financial asset (= proceeds)

If the transfer of the asset is a sale then the following rules apply:

Seller-Lessee

- Derecognise the PPE
- Recognise the sale at fair value
- Recognise lease liability (PV of lease rentals)
- Recognise a right-of-use asset, as a proportion of the previous carrying value of underlying asset
- Gain/loss on rights transferred to the buyer

Buyer-Lessor

- Recognise purchase of the PPE
- Apply lessor accounting

Example 7 – Sale and leaseback

Apple required funds to finance a new ambitious rebranding exercise. It's only possible way of raising finance is through the sale and leaseback of its head office building for a period of 10 years. The lease payments of $1 million are to be made at the end of the lease period

The current fair value of the building is $10 million and the carrying value is $8.4 million. The interest rate implicit in the lease is 5%.

Advise Apple on how to account for the sale and leaseback in its financial statements if the office building were to be sold at the fair value of $10 million and:
i) Performance obligations are not satisfied; or,
ii) Performance obligations are satisfied.

Note: If the proceeds are less than the fair value of the asset or the lease payments are less than market rental the following adjustments to sales proceeds apply:

- Any below-market terms should be accounted for as a prepayment of the lease payments; and,
- Any above-market terms should be accounted for as additional financing provided to the lessee.

6. SUB-LEASES

Assume that a building has a life of 100 years, and that A leases the building to B for 90 years (HEAD-LEASE); B then sub-lets the building to C (SUB-LEASE).

How will B reflect these transactions its financial statements?

In terms of the HEAD-LEASE, B would normally recognise a **right of use asset** and **a lease liability** in its SFP, and **depreciation** and **finance costs** in its SPL.

Initial recording of the HEAD-LEASE would be:

Dr Right of use asset x Cr Lease liability x

But what is the impact of the SUB-LEASE?

Scenario 1 – B sub-lets the building for 90 years.

As the SUB-LEASE is for the majority of the asset's life, B will treat the transaction as a **finance lease.** Therefore, B will recognise a **lease receivable ('net investment in finance lease')** in its SFP and **finance income** in its P&L. The **right of use asset** will be derecognised.

Initial recording of the lease would be:

Dr Lease receivable x Cr Right of use asset x

(Any difference between the lease receivable and the right of use asset would be recognised in the P&L).

Scenario 2 – B sub-lets the building for 10 years.

As the SUB-LEASE is **not** for the majority of the asset's life, B will treat the transaction as an **operating lease.** Therefore, B will recognise **rental income** in its SPL. The **right of use asset** will not be derecognised.

Chapter 19

INVENTORY

1. Inventory (IAS 2)

Measure @ lower of

Cost

Costs incurred in bringing inventory to its present condition and location

- Materials
- Labour
- Manufacturing overheads (based on normal output)

NRV

Selling price	X
Less:	
Costs to complete	(X)
Costs of selling	(X)
NRV	X

Note:

Biological assets / agricultural produce (IAS 41) is valued at fair value less costs to sell until harvested

Example 1 – Inventory

Bravo manufactures components for the retail industry. The inventory is currently valued at cost.

The cost structure of the equipment is as follows:

	Cost per unit	*Selling price per unit*
	$	*$*
Production process – 1st stage	1,000	1,050
Conversion costs – 2nd stage	500	
Finished product	1,500	1,700

The selling costs are $10 per unit and Bravo has 100,000 units at the first stage of production and 200,000 units of finished product.

Shortly after the year-end a competitor released a new model and this has resulted in Bravo having to reduce it selling price to $1,450 for the finished product and $950 for the first stage of production.

Calculate the value of closing inventory to be included in Bravo's financial statements at the reporting date.

Chapter 20

DEFERRED TAX (IAS 12)

Deferred tax arises on temporary differences between the carrying value of an asset or liability and its tax base.

1. Calculating deferred tax

1. Calculate the the temporary difference, as being the difference between the carrying vale of the asset or liability and its tax base.

	$'000s
Carrying value	X
Tax base	X
Temporary difference	X

2. Calculate the deferred tax position by multiplying the temporary difference by the income tax rate at which the asset or liability will be settled at.
X% x temporary difference = closing deferred tax provision

3. The closing deferred tax position is either a deferred tax asset or a liability.

A deferred tax liability arises if:
Carrying value > Tax base – taxable temporary difference

A deferred tax asset arises if:
Carrying value < Tax base – tax deductible temporary difference

4. The movement in the deferred tax position usually goes through profit or loss.

	$'000s
Closing position	X
Opening position	X
Movement	X/(X)

Increase in deferred tax

Dr Income tax expense (SPL)

Cr Deferred tax provision

Decrease in deferred tax

Dr Deferred tax

Cr Income tax expense (SPL)

Note that the movement sometimes goes to OCI (e.g. revaluations of PPE) or goodwill (e.g. fair value adjustments). These are considered later in the chapter.

2. Individual company accounts

1. Property, plant and equipment

Carrying value (IAS 16)	vs.	Tax base
X		X

Tax written down value

2. Provisions

Carrying value (IAS 37)	vs.	Tax base
(X)		Nil

3. Intangibles (development costs)

Carrying value (IAS 38)	vs.	Tax base
X		Nil

4. Share based payments

Carrying value (~~IFRS 2~~)	vs.	Tax base
(X)		Nil

Intrinsic value

Example 1 – Accelerated capital allowances

Osborne buys an asset for $150,000 at the start of the financial year. The asset has an estimated life of 6 years and an estimated residual value of $30,000.

Capital allowances are available at a rate of 25% reducing balance and the tax rate is 20%.

Calculate the deferred tax asset/liability to appear in the statement of financial position for the next three years and the debit/credit charged to the tax expense in the statement of profit or loss for the same period.

Example 2 – Share based payments

Brown has granted 1,000 equity settled share based payment scheme to each of its 100 employees. The vesting period is four years and no employees are expected to leave over this period.

The fair value of the option at the grant date was $2 and its intrinsic value at the end of the first year was $1.60.

Calculate the deferred tax balance to appear in the statement of financial position at the end of the first year in relation to the share based payment scheme.

Example 3 – Revaluations

Clarke bought a property for $500,000 on 1 January 2015.

On 31 December 2015 the property had a carrying value of $480,000 and was revalued to $800,000. The tax written down value at 31 December 2015 was $420,000 and the tax rate is 20%.

Explain how the revaluation, including any deferred tax impact, should be dealt with in Clarke's financial statements for the year-ended 31 December 2015.

3. Losses

If an entity has unused tax losses to carry forward, a deferred tax asset should be recognised to the extent that it is possible that future taxable profits will be available against which the losses will be offset.

4. Group accounts

- Fair value adjustments

  The assets and liabilities of the subsidiary are consolidated at fair value, which will give rise to temporary differences as the tax will have been calculated by the tax authorities using their original costs.

  The fair values of the consolidated assets and liabilities are usually higher than their book value so the temporary difference will give rise to an additional deferred tax liability (carrying value > tax base).

  The deferred tax liability is recorded in the group statement of financial position and the opposing entry taken to consolidated goodwill.

- Goodwill

  The calculation of goodwill in the consolidated financial statements does not give rise to a temporary difference as the tax authorities will never recognise goodwill. It is therefore considered to be a **permanent difference** and no deferred tax arises.

- PUP adjustments

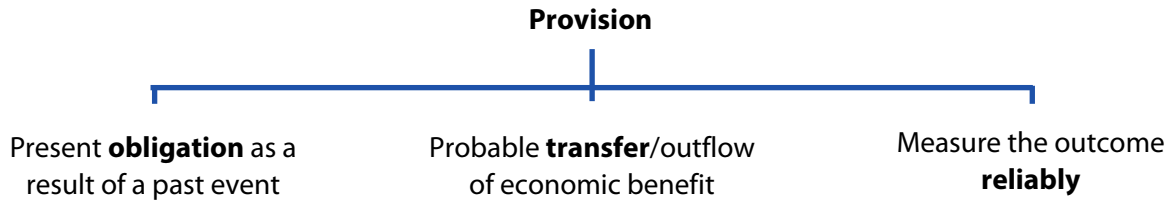
  Profit made on sale between group companies whereby the inventory is still in the group at year end are eliminated as a PUP adjustment. Accordingly therefore any tax on the profit made will need to be eliminated which will give rise to a deferred tax asset.

  On subsequent sale of the goods outside of the group in subsequent years the deferred tax asset can be released.

Relevant examiner articles on the ACCA (students) website:
Deferred tax

Chapter 21

PROVISIONS, CONTINGENT ASSETS AND LIABILITIES (IAS 37)



1. Measurement

- Best estimate of expenditure
- Expected values (various different outcomes)
- Discount to present value if materially different

2. Subsequent treatment

- Review the provision annually
- Only use the provision for expense originally created

Example 1 – Provisions and contingent liabilities

York operates in the oil industry and is regularly involved in the contamination of land, seas and rivers given the nature of the business. It does however have a publicised environmental policy on its website and in its annual report that states that it will clean up any environmental damage incurred.

It is currently involved in three major projects where the costs of cleaning up the contamination and the local laws regarding environmental clean-up are given.

Environmental clean-up costs	*Local laws*
$4 million	Law enforces the clean-up of environmental damage
$5 million	No law exists for the clean-up of environmental damage
$6 million	Law to enforce clean -p of environmental damage will come into force in the next accounting period

Explain how York should account for the above environmental clean-up costs in its financial statements.

3. Specifics

Future operating losses
No provision can be made for anticipated losses as there is no obligation.

Onerous contracts
An onerous contract is whereby the cost of fulfilling the contract exceed the benefits received from the contract.

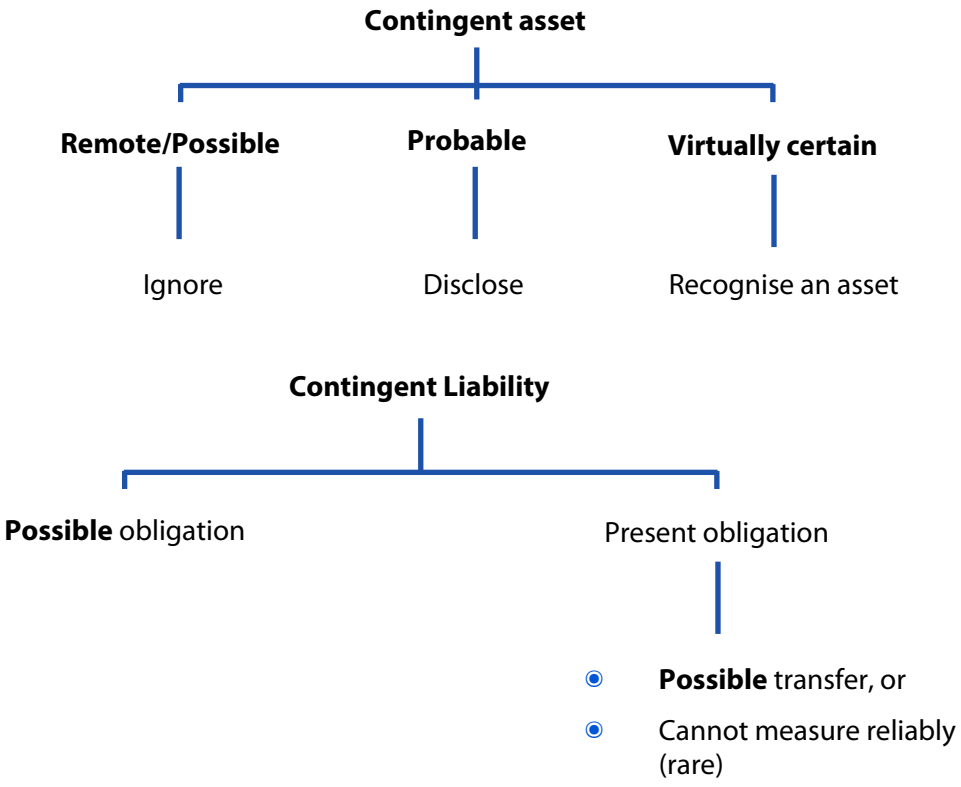
Restructuring

- Sale or closure of a line of business
- Ceasing activities in a geographical location
- Relocating activities
- Re-organisation (management or focus of operations)

A provision is recognised if there is a detailed formal plan and the plan has been announced.
The provision only includes costs which are necessarily to be incurred and not associated with continuing activities.

Environmental provisions
Assume that a company builds a wind farm. The cost of construction is $40 million. At the end of the wind farm's life, the company is required by law to demolish the wind farm and clean up the site. The present value of this cost is $8 million.
What is the double entry at the time of construction of the wind farm?
Dr PPE 48 million Cr Cash 40 million Cr Provision 8 million.

4. Contingent liabilities and assets



Chapter 22

EVENTS AFTER THE REPORTING DATE (IAS 10)

IAS 10

Adjusting

Information relating to a condition that existed at the reporting date

- Settlement of outstanding court case
- Bankruptcy of a customer
- Sale of inventory at below cost
- Determination of purchase/sale price of PPE

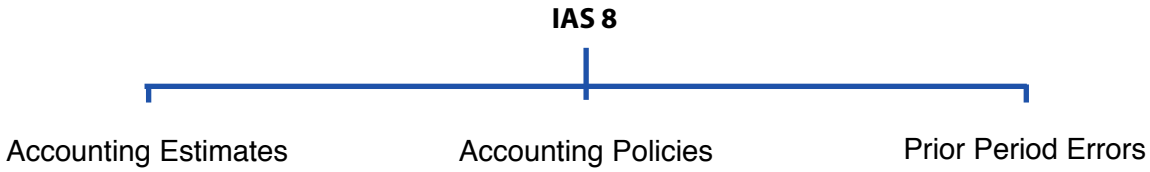
Non-adjusting

Doesn't reflect conditions that existed at the reporting date

- Fall in value of investments
- Major purchase of assets
- Announcing a discontinued operation
- Announcing a restructuring

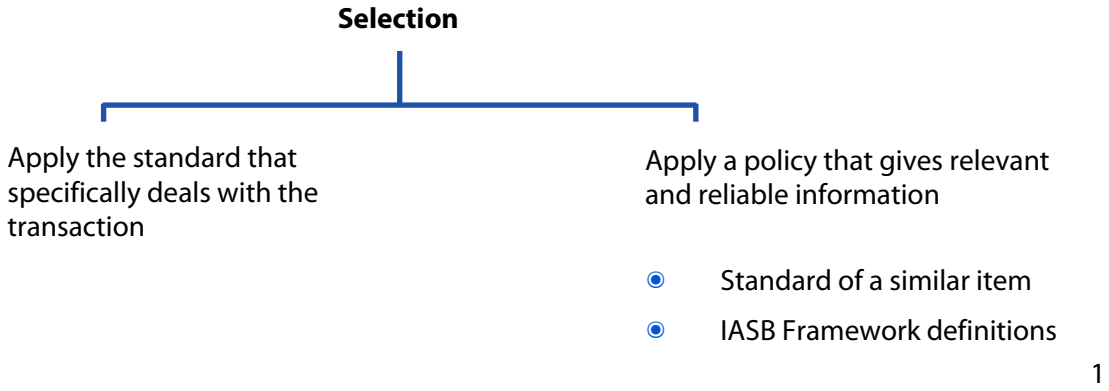
Chapter 23

ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATE AND ERRORS (IAS 8)



1. Accounting policies

The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting the financial statements.



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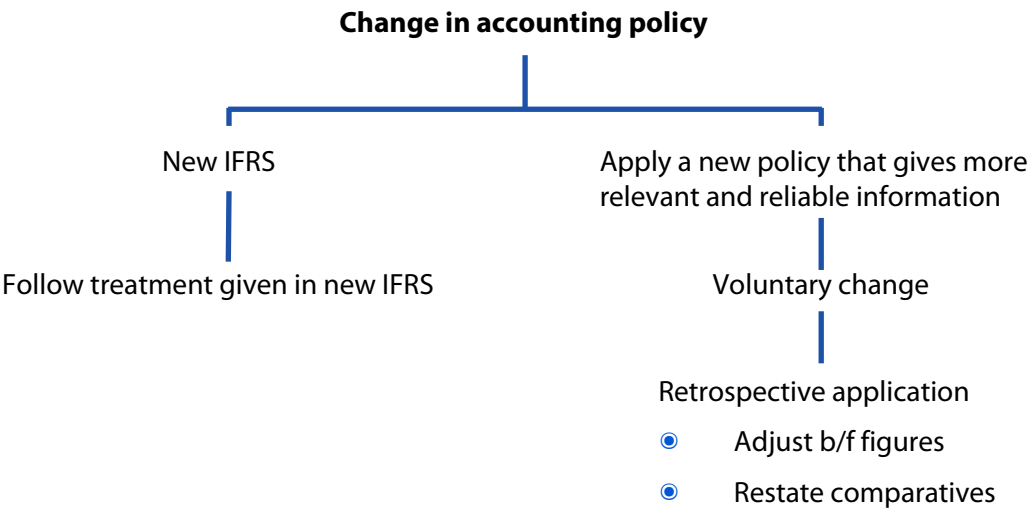

2. Accounting estimates

Changes in accounting estimate are recognised prospectively:

- Period of change
- Period of change and future periods

Illustration 1 – Accounting Estimates

If a company decides to change its method of depreciation from straight line method to reducing balance method.

3. Prior period error

Accounting errors (omissions and misstatements) include:

- Errors in applying accounting policies
- Oversights
- Fraud and the effects of fraud

Material errors are corrected retrospectively, the same as for a change in accounting policy.

Chapter 24

RELATED PARTIES (IAS 24)

1. Related party

A party is related to an entity if it either:

- controls, is controlled by, or is under common control with, the entity
- has an interest in the entity that gives a significant influence over the entity
- has joint control over the entity
- is an associate (IAS 28 Investment in Associates)
- is a joint venture in which the entity is a venturer (IAS 31 Interests in joint ventures)
- is a member of the key management personnel of the entity or its parent
- is a close family member of any of the above
- is a post-employment benefit plan for the employees of the entity or of any entity that is a related party of the entity

2. Related party transactions

- Purchase or sale of goods/components
- Purchase or sale of asset/property
- Provision and receipt of services
- Leasing (operating/finance)
- Research and development transfers
- Settlement of another party's liabilities

3. Key management personnel

Those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director of that entity.

4. Related party disclosures

Relationships between parents and subsidiaries shall be disclosed irrespective of whether there have been transactions between those related parties.

- Name of entity's parent and;
- If different the ultimate controlling party

5. Disclosure of transactions and balances generally

If there have been transactions between related parties, an entity should disclose the nature of the related party relationships as well as information about the types of transactions and the outstanding balances necessary for an understanding of the financial statements.

Disclosure should be made irrespective of whether a price is charged.

At a minimum the disclosure should include:

- The amount of the transactions
- The amount of outstanding balances, including terms and conditions, whether they are secured and the nature of the consideration to be provided
- Provisions for doubtful debts based on the amount outstanding
- The expense recognised during the period in relation to bad and doubtful debts

The above should be made separately for each of the following

- The parent
- Entities with joint control or significant influence over the entity
- Subsidiaries
- Associates
- Joint ventures in which the entity is a venture
- Key management personnel
- Other related parties

6. Disclosure of key management personnel compensation

Key management personnel compensation in total and for each of the following;

- Short-term employee benefits
- Post-employment benefits
- Other long term benefits
- Share based payments

Note: Providers of finance, trade unions, utility providers, government departments, customers and suppliers are NOT related parties.

Chapter 25

EARNINGS PER SHARE (IAS 33)

1. Basic Earnings per Share

$$\text{Basic Earnings per Share} = \frac{\text{Profit attributable to ordinary shareholders of the parent}}{\text{Weighted average number of shares}}$$

If the number of shares has changed during the period the following assumptions are made regarding the weighted average number of shares:

- **Full price issue** — Normal weighted average calculation
- **Bonus issues** — Assume that the bonus shares have always been in issue (and therefore alter the comparative EPS amount)
- **Rights issue** — Assume that the shares issued are a mix of bonus and full price shares. For the bonus element assume that they have always been in issue and therefore adjust the comparative

If bonus issues or rights issues occur after the reporting date, but before the date of approval of the accounts the EPS should be calculated based on the number of shares following the issue.

2. Diluted earnings per share

This is calculated where potential ordinary shares have been outstanding during the period which would cause EPS to fall if exercised (dilutive instruments).

The earnings should be adjusted by adding back any costs that will not be incurred once the dilutive instruments have been exercised. This will include for post-tax interest saved on convertible debt.

The number of shares will be adjusted to take account of the exercise of the dilutive instrument. This means that adjustment is made:

- **For convertible instruments** — By adding the maximum number of shares to be issued in the future
- **For options** — By adding the number of effectively "free" shares to be issued when the options are exercised

Chapter 26

SMALL AND MEDIUM SIZED ENTITIES

Small and medium sized entities are entities that do not have public accountability. This can be either unlisted entities or a non-financial institution.

IFRSs for Small and Medium-sized entities

The *IFRS for SMEs* is a self-contained Standard (less than 250 pages), designed to meet the needs and capabilities of small and medium-sized entities (SMEs), which are estimated to account for over 95 per cent of all companies around the world.

Compared with full IFRS (and many national GAAPs), the *IFRS for SMEs* is less complex in a number of ways:

- Topics not relevant for SMEs are omitted; for example earnings per share, interim financial reporting and segment reporting.
- Many principles for recognising and measuring assets, liabilities, income and expenses in full IFRS are simplified. For example, amortise goodwill; recognise all borrowing and development costs as expenses; cost model for associates and jointly-controlled entities; and undue cost or effort exemptions for specific requirements.
- Significantly fewer disclosures are required (roughly a 90 per cent reduction).
- The Standard has been written in clear, easily translatable language.
- To further reduce the burden for SMEs, revisions are expected to be limited to once every three years.

Chapter 27

INTEGRATED REPORTING <IR>

The International Integrated Reporting Council has issued a Framework that gives the principles and concepts that govern the content of an integrated report. It aims to communicate how an entity will create value over time and identify the key drivers of its value. To do this requires relevant financial and non-financial information.

1. Fundamental Concepts

'An integrated report aims to provide insight about the resources and relationships used and affected by an organisation – these are collectively referred to as "the capitals"

The capitals are stocks of value that are increased, decreased or transformed through the activities and outputs of the organisation. They are categorised in this Framework as:

- Financial
- Manufactured
- Intellectual
- Human
- Natural
- Social and relationship

2. Guiding Principles

A key factor in the development of the framework is that previous attempts to highlight non-financial factors, notably the management commentary and the Operating and Financial Review (OFR), became too cluttered and focussed on the positives and not the negatives. The <IR> framework has therefore recommended Guiding Principles to aid the content of the report and how it is presented.

The Guiding Principles that underpin the preparation and presentation of an integrated report are:

- Strategic focus and orientation
- Connectivity and information
- Stakeholder relationships
- Materiality
- Conciseness
- Reliability and completeness
- Consistency and comparability

3. Content Elements

The key components of an integrated report are as follows:

- Organisational overview and the external environment under which it operates.
- Governance structure and how this supports its ability to create value.
- Business model.
- Risks and opportunities and how they are dealing with them and how they affect the company's ability to create value.
- Strategy and resource allocation.
- Performance and achievement of strategic objectives for the period and outcomes.
- Outlook and challenges facing the company and their implications.
- Basis of preparation and presentation

Relevant examiner articles on the ACCA (students) website:
Integrated reporting

ETHICS AND CURRENT DEVELOPMENTS

Chapter 28

ETHICS

Directors are responsible for the preparation of the financial statements. The financial statements are to be prepared following IFRS and must show a true and fair view of the entity, however directors may try to manipulate information to:

- Increase their pay/bonuses
- Deliver specific targets e.g. EPS
- Reduce risk of insolvency e.g. through avoiding breach of loan covenants
- Avoiding regulatory interference
- Improve the appearance of part or all of the business prior to an IPO/disposal
- Understate revenue and overstate expenses to reduce tax liabilities

If the financial statements have not been prepared in accordance with IFRS then this may bring about ethical issues as the directors may not have been acting in a professional manner in accordance with their fiduciary duties.

The way in which directors can do this is as follows:

- Window dress the year-end financial statements
- Exercise judgement in applying accounting standards
- Inappropriate recording of transactions

Ethical issues commonly arise where there is a choice of accounting treatments that could be used in preparation of the financial statements. This could involve deliberate overstatement of assets, understatement of liabilities which may then impact on the performance or profitability.

Areas where ethical issues could arise are:

Leases	Classification as short-term lease
Financial assets	Impairment
PPE	Capex. vs. Revex.
Intangibles	Research and development
Goodwill	Fair value vs. Proportionate share

Exam tip:

Practice all the past exam questions covering ethics

Exam technique for ethics questions

1. Explain any relevant accounting rules which have been breached.
2. Mention that the directors' actions are not in line with ACCA Code of Ethics.
3. Explain and apply which PRINCIPLES have been breached. The most likely are:
   a. Integrity – in manipulating financial information, directors have not acted with STRAIGHTFORWARD BUSINESS CONDUCT.
   b. Professional competence – if directors are unaware of a particular accounting rule, they have failed to MAINTAIN PROFESSIONAL KNOWLEDGE.
   c. Professional behaviour – may be relevant if you consider that the directors' conduct could DISCREDIT PROFESSION.
4. Consider whether there has been an issue with any threats to objectivity. If directors have acted in a particular way in order to maximise their share-based pay, this would present a SELF-INTEREST threat.
5. Explain any relevant actions that should be taken:
   - discussion with those charged with governance / audit committee
   - seeking advice from the ACCA / seeking legal advice
   - resignation etc

Chapter 29

MANAGEMENT COMMENTARY AND INTERPRETATION OF FINANCIAL STATEMENTS

1. Management commentary

In December 2010 The International Accounting Standards Board (IASB) published an International Financial Reporting Standard (IFRS) Practice Statement *Management Commentary*, a broad, non-binding framework for the presentation of narrative reporting to accompany financial statements prepared in accordance with IFRSs.

Management commentary fulfils an important role by providing users of financial statements with a historical and prospective commentary on the entity's financial position, financial performance and cash flows. It serves as a basis for understanding the management's objectives and strategies for achieving those objectives.

The Practice Statement permits entities to adapt the information provided to particular circumstances of their business, including the legal and economic circumstances of individual jurisdictions. This flexible approach will generate more meaningful disclosure about the most important resources, risks and relationships that can affect an entity's value, and how they are managed.

The Practice Statement is not an IFRS. Consequently, an entity need not comply with the Practice Statement to comply with IFRSs.

The Practice Statement suggests the commentary should include narrative and numerate information about:

- Nature of the business
- Management's objectives
- Strategies for achieving the objectives
- Entity's most significant resources, risks and regulations
- Results of operations and prospects
- Critical performance measures and indicators (financial/non-financial)

2. Interpretation of financial statements

Stakeholder analysis

Remember that different stakeholders are interested in different information:

- Investors and potential investors may be primarily interested in PROFITABILITY.
- Lenders and suppliers may be primarily interested in the survival of the company in the short term (LIQUIDITY) and the long term (SOLVENCY).

Traditional ratio analysis

When you studied Financial Reporting you learned the basic ratios:

- Performance – ROCE, profit margin
- Liquidity – Current and acid test ratio
- Efficiency – Asset turnover, Inventory days, receivable days, payable days
- Solvency – gearing ratio, interest cover
- Investor – EPS, PE ratio, dividend cover

If you need to revise these ratios, please review the relevant chapters and lectures in the Open Tuition Financial Reporting materials.

Alternative performance measures (APMs)

For SBR, you also need to be familiar with EBITDA / EBITDAR.

- EBITDA – Earnings before interest, tax, depreciation, tax and amortisation
- EBITDAR – As EBITDA but also add back rental expense.

EBITDA is widely used to analyse businesses because it does not allow the underlying result to be distorted by 'arbitrary / subjective' decisions about depreciation and amortisation.

However, EBITDA is NOT cash flow, because it takes no account of the movements in working capital. For example, a business with a positive EBITDA can still find itself in trouble if it ties all its money in inventory which may prove difficult to sell.

ESMA Guidelines

There is concern that users may be misled by so-called 'alternative performance measures' in financial statements. In Europe the European Securities and Markets Authority have produced guidelines. If you learn these, they could be very useful in a discussion question. The principal guidelines are as follows:

1. APMs should be clearly defined in the financial statements.
2. A reconciliation should be published between the APM and the 'traditional' measure. For example, EBITDA should be reconciled to 'earnings', as used in Earnings per Share.
3. The relevance and reliability of any APMs used should be explained.
4. APMs should not be more prominent than traditional measures (e.g. EPS).
5. APMs should presented alongside comparatives for the prior year.
6. The method of calculation of the APM should be consistent from year to year.

Relevant examiner articles on the ACCA (students) website:

Additional performance measures

Giving investors what they need

Using the business model of a company to help analyse its performance

Chapter 30

CURRENT ISSUES AND SUSTAINABILITY

1. Making Materiality Judgements (IFRS Practice Statement)

Note the definition of material:

- Information is material if omitting, misstating or OBSCURING it could reasonably be expected to influence decisions of the primary users of financial statements.

Learn the 4 steps that an entity should follow in assessing what is material for inclusion in the financial statements.

1. Identify information that may be material for primary users – providers of finance.
2. Assess whether this information is actually material by size or nature.
3. Present the information clearly and concisely.
4. Stand back and look at the information as a whole to see what may need to be added or deleted.

2. Accounting for a natural disaster / global event

Recent events have taught us that a natural disaster, such as a pandemic, can have far-reaching implications for the financial statements.

A scenario question may ask you to consider the impact of such an event. Examples of standards which would be relevant are set out below. (You may be able to think of other standards that are relevant).

IAS 1 Presentation of financial statements

It is possible that there are going concern issues:

- If the entity is now insolvent, the financial statements will have to be prepared on a break-up/ liquidation basis;
- If (as is more likely) the business is not yet insolvent, but faces going concern uncertainties, appropriate disclosures must be made in the notes to the financial statements.

IAS 2 Inventories

If products cannot be sold then net realisable value may be less than cost.

IAS 20 Accounting for government grants and disclosure of government assistance

In the event of government support being received (e.g., the furloughing of employees), the benefit of such support must be matched to the underlying expenses in the profit and loss account.

IAS 36 Impairment of assets

A global catastrophe is clearly an impairment indicator. The entity must calculate the recoverable amount of the relevant cash generating units, and any loss would normally be recognised in the profit and loss account.

IAS 37 Provisions, contingent liabilities and contingent assets

Businesses may need to reorganise: if redundancies are necessary, provisions should be recognised if there is a constructive obligation (detailed plan communicated to those affected before the reporting date).

IFRS 9 Financial instruments

Bad debts may be inevitable. If, for example, these are regular trade receivables, the business must make an allowance for total expected credit losses. (Remember that the complex 'three stage model' applies to loan assets but not to trade receivables).

3. Accounting issues – climate change

3.1 INTRODUCTION

1. The IASB Foundation set up a body known as the International Standards Sustainability Board (ISSB).
2. Membership is global with members from Africa, America, Asia-Oceania and Europe. Thus, the ISSB is not dominated by the views of one country (or continent).
3. The ISSB is developing IFRS Sustainability Disclosure Standards.
4. Two standards have been issued and these are summarised below.

3.2 IFRS S1 STANDARD – DISCLOSURE OF SUSTAINABILITY-RELATED FINANCIAL INFORMATION

OBJECTIVE

To require an entity to disclose information about its sustainability-related risks and opportunities that is useful to **primary users** of financial statements in making decisions relating to providing resources to the entity.

SCOPE

An entity may apply IFRS Sustainability Disclosure Standards whether or not its financial statements are prepared in accordance with IFRS.

CONCEPTUAL FOUNDATIONS

The six characteristics of financial information set out in the Conceptual Framework apply here.

For sustainability-related financial information to be useful, it must be **relevant** and **faithfully represent** what it claims to represent. The usefulness of sustainability-related financial information is enhanced if the information is **comparable**, **verifiable**, **timely** and **understandable**.

In terms of **verifiability**, there are concerns that companies may make unverifiable claims in their Annual Report in terms of, for example, pollution, carbon emissions and recycling. This practice is sometimes known as **greenwashing**.

In the context of sustainability-related financial disclosures, information is material if omitting, misstating, or obscuring that information could reasonably be expected to influence decisions that **primary users** of general-purpose financial reports make.

Data and assumptions used in preparing the sustainability-related financial disclosures shall be **consistent** with the prior year data and assumptions used in preparing the related financial statements.

CORE CONTENT

Disclosures should be made in respect of:

1. Governance.
2. Strategy.
3. Risk management; and
4. Metrics and targets.

Disclosures on **governance** will enable users to understand the governance processes, controls and procedures an entity uses to monitor, manage and oversee sustainability-related risks and opportunities. Examples would be:

- how and how often the board is informed about sustainability-related risks and opportunities.
- how the board oversees the setting of targets related to sustainability-related risks and opportunities.

Disclosures on **strategy** will enable users to understand an entity's strategy for managing sustainability-related risks and opportunities. Examples would be:

- a description of the current and anticipated effects of sustainability-related risks and opportunities on the entity's business model.
- the effects of sustainability-related risks and opportunities on the entity's financial position, financial performance and cash flows for the reporting period (current financial effects).

Disclosures on **risk management** will enable users to understand an entity's processes to identify, assess, prioritise and monitor sustainability-related risks and opportunities. Examples would be:

- whether and how the entity prioritises sustainability-related risks relative to other types of risk.
- whether and how the entity has changed the processes it uses compared with the previous reporting period.

Disclosures on **metrics and targets** will enable users to understand an entity's performance in relation to its sustainability-related risks and opportunities. Examples would be:

- how the metric is defined.
- whether the metric is validated by a third party and, if so, which party.

GENERAL REQUIREMENTS

An entity shall report its sustainability-related financial disclosures at the same time as its related financial statements. The entity's sustainability-related financial disclosures shall cover the same reporting period as the related financial statements.

An entity whose sustainability-related financial disclosures comply with all the requirements of IFRS Sustainability Disclosure Standards shall make an explicit and unreserved **statement of compliance**. An entity shall not describe sustainability-related financial disclosures as complying with IFRS Sustainability Disclosure Standards unless they comply with **all** the requirements of IFRS Sustainability Disclosure Standards.

JUDGEMENTS UNCERTAINTIES AND ERRORS

An entity shall disclose information to enable users to understand the **judgements** made and **uncertainties** considered in the process of preparing its sustainability-related financial disclosures.

An entity shall correct material prior period errors by restating the comparative amounts for the prior period(s) disclosed unless it is impracticable to do so.

3.3 IFRS S2 STANDARD – CLIMATE-RELATED DISCLOSURES

OBJECTIVE

To require an entity to disclose information about its climate-related risks and opportunities that is useful to **primary users** of financial statements in making decisions relating to providing resources to the entity.

SCOPE

The Standard applies to climate-related **risks** to which the entity is **exposed**, and climate-related **opportunities available** to the entity.

Climate-related **risks** may be **physical** or **transition**.

Physical risks arise, for example, from adverse climate-related events such as fires and floods.

Transition risks arise as economies transition to less carbon usage (e.g. the move from diesel to electric cars).

CORE CONTENT

Disclosures should be made in respect of:

1. Governance.
2. Strategy.
3. Risk management; and
4. Metrics and targets.

The content of IFRS S2 is similar to S1, but it makes reference to **climate-related** (as opposed to **sustainability-related**) issues throughout.

However, it would be worth learning a few of the specific climate-related **metrics**:

- Gross greenhouse gas emissions (metric tonnes of carbon dioxide).
- Amount of capital expenditure on climate-related risks and opportunities.
- Percentage of executive remuneration linked to climate-related considerations.

3.4 FINALLY – A NOTE ABOUT EUROPEAN STANDARDS

The European Union has produced a set of sustainability standards known as the European Sustainability Reporting Standards (ESRS). You are expected to understand the principal differences. Examples are:

1. IFRS Sustainability Standards are intended only for **primary users** of the financial statements whereas ESRS are for a far wider range of stakeholders.
2. There are significantly **more ESRS** than IFRS Sustainability Standards.
3. ESRS apply a concept known as '**double materiality**':
   (a) Financial materiality which would impact investor decisions.
   (b) Impact materiality which would consider the impact of the company on people or the environment.

Relevant examiner articles on the ACCA (students) website:

Cryptocurrencies
Climate related disclosures and investor focus
Sustainable development goals

ACCA PAPER SBR
UK VS IFRS DIFFERENCES

1. UK Syllabus

The SBR syllabus for the UK variant paper replaces section C.10 Reporting requirements of small and medium-sized entities (SMEs) in the international variant with the following:

(a) Discuss the financial reporting requirements for UK and Republic of Ireland entities (UK GAAP) and their interaction with the Companies Act requirements.

(b) Discuss the reasons why an entity might choose to adopt UK GAAP.

(c) Discuss the scope and basis of preparation of financial statements under UK GAAP.

(d) Discuss the concepts and pervasive principles set out by UK GAAP

(e) Discuss and apply the principal differences between UK GAAP and IFRS.

2. Background

UK GAAP previously consisted of FRSs and SSAPs, which were the equivalent to IFRSs and IASs. UK GAAP now consists of six standards that have been published by the Financial Reporting Council (FRC):

- FRS 100 Application of Financial Reporting Requirements
- FRS 101 Reduced Disclosure Framework
- FRS 102 The Financial Reporting Standards applicable in the UK and Republic of Ireland
- FRS 103 Insurance Contracts
- FRS 104 Interim Financial Reporting
- FRS 105 The Financial Reporting Standards applicable to the Micro-entities regime

FRS 100 provides direction on which standard and entity should be applying. FRS 101 applies to individual entities that prepare accounts under IFRS, in order to facilitate consolidation, that allows for reduced disclosure in the individual entity accounts.

FRS102 is based upon the IFRSs for SMEs and grouped into 34 separate chapters each one dealing with a particular accounting area and is used by UK unlisted groups (listed groups use full IFRS) and listed and unlisted individual entities.

FRS 105 cannot be applied by subsidiaries that are fully consolidated in group accounts or parent companies that prepare group accounts.

3. Key differences

The key differences between UK GAAP (FRS 102) and IFRS are summarised below:

IASB Conceptual Framework / Concepts and principles

International rules allow measurement using four bases (historic cost, present value, replacement cost and fair value), whilst FRS102 allows only two measurement bases (historic cost and fair value).

FRS102 separately identifies materiality, substance over form and prudence as qualitative characteristics, whereas they aren't in the IASB Conceptual Framework.

Events after the end of the Reporting Period

FRS102 allows dividends declared after the reporting date to be presented as separate component of retained earnings.

Property, plant and equipment

FRS102 reviews changes in residual value and useful lives when indicators of change are present. IFRS requires annual reviews of the residual value and useful lives at the end of each reporting period.

Borrowing costs

IFRS must capitalise but FRS 102 allows an accounting policy choice with regards to capitalising or expensing the borrowing costs.

Related Party Disclosures

Transactions between the parent and a wholly owned subsidiary are exempt from disclosure under FRS102.

Income taxes

No significant differences in the treatment of current tax.

FRS 102 adopts a slightly different approach using a timing differences vs temporary differences approach. Timing differences are measured by comparing the PBT to PCTCT, as opposed to carrying value versus tax base under IFRS. The resulting deferred tax is very often the same.

Foreign Currency Translation

A foreign currency translation reserve is not used in FRS102.

Group Accounts (exclusion of subsidiary)

A subsidiary should be excluded from consolidation where:

(a) Severe long-term restrictions substantially hinder the exercise of the rights of the parent over the assets or management of the subsidiary; or

(b) The interest in the subsidiary is held exclusively with a view to subsequent resale; and the subsidiary has not previously been consolidated in the consolidated financial statements prepared in accordance with FRS 102.

Investments in Associates

Goodwill is recognised on acquisition of an associate/joint venture under FRS102, which is then amortised.

Intangibles

Capitalisation of development costs is an accounting policy choice.

Intangibles are amortised over their useful life, and if an estimate cannot be made then the useful life is 10 years, whereas IFRS has indefinite life intangibles.

Investment property

Investment property must be carried at FV under FRS 102.

Goodwill

Transaction costs are capitalised under FRS102 but are expenses under IFRS.

Contingent consideration is included within the cost of the investment under FRS102 if it is probable and can be measured reliably. It is recognised at fair value under IFRS.

FRS102 uses the proportionate share method for calculating goodwill, whereas IFRS uses both the fair value method and the proportionate share method.

Goodwill is amortised over its useful life, which if unable to be determined is taken as not exceeding ten years.

There is less detail on fair value measurement in FRS102 compared with IFRS.

Negative goodwill should be recognised on the SFP and amortised in the same was as positive goodwill.

Discontinued operations and assets held for sale

FRS 102 does not account for assets held for sale, with the decision to sell being classified as an impairment indicator.

FRS102 shows the results of discontinued operations in a separate column in the income statement as opposed to in a single line item as under IFRS 5.

Financial instruments

FRS102 splits the rules on financial instruments into basic and other financial instruments, with basic being measured at amortised cost and other at fair value through profit or loss. There is no FVTOCI measurement basis.

FRS102 uses an incurred loss model compared to the expected loss model under IFRS 9, which results in earlier recognition of impairments under international rules.

Revenue

Revenue on sale of goods to be recognised on transfer of risks and rewards. Revenue on sale of services to reflect performance of contract to date.

There is no 5-step approach used in FRS 102.

NOTE: High level principles may be examined in a narrative question but detailed transactions will not be examined.

Leases

In lessee accounting, leases which transfer risks and rewards referred to as finance leases and capitalised. Other leases referred to as operating leases and expensed.

NOTE: High level principles may be examined in a narrative question but detailed transactions will not be examined.

4. Questions

1. Which of the following measurement bases are allowed by FRS102?
2. Which of the following measurement bases are not allowed by FRS102?
3. Where does FRS102 allow accounting policy choices whereas IFRS does not?
4. Explain the accounting treatment of goodwill under IFRS 3 Business Combinations and how it is different under FRS102.

5. Solutions

1. Historic cost and fair value
2. Current cost and present value
3. Accounting policy choices are allowed for both borrowing cost and development costs. Under FRS102 they can either be capitalised or expensed.
4. Goodwill is capitalised as an intangible non-current asset under both IFRS and UK GAAP, however its initial measurement and subsequent treatment is different

IFRS 3 allows the goodwill to be calculated using both the proportionate method and the fair value method. The proportionate share method measures the parent's goodwill only, whilst the fair value method results in a higher value as it includes the non-controlling interest goodwill also.

Negative goodwill is recognised immediately through profit or loss.

Goodwill is then subject to annual impairment reviews under IFRS.

FRS102 does not allow the fair value method for goodwill, whilst it is also amortised over its useful life. If this cannot be estimated, then it should not exceed ten years. Negative goodwill is recognised against positive goodwill on the statement of financial position, once its accuracy has been validated through remeasurement and reassessment of the elements of the calculation (cost and net assets).

EMPLOYABILITY AND TECHNOLOGY SKILLS

1. Introduction

The ACCA has introduced this new section into the syllabus for all of the Applied Skills and Strategic Professional examinations now that all the examinations in all locations will be computer based.

However, it does not require the same sort of learning as for other syllabus areas because it is primarily focused on ensuring that students are capable of using the Computer Based Exam software.

The level of skill needed to be able to use the CBE software can also be beneficial for your employment.

Many students will already have a high level of skill on computers and be familiar with the use of word processors and spreadsheets. However, those provided in the exam software might not be identical to those that you are familiar with and, in addition, it is essential that you are able to navigate the software efficiently so as not to waste time in the exam.

There are many excellent resources available on the ACCA website to assist you, and so in this chapter we will direct you to some of the relevant ACCA pages and explain their importance.

2. Navigating the exam and the tools available

The exam screen has a top bar and a bottom bar.

On the **top bar** there are options to call up an 'online calculator', to call up the 'scratch pad', and to 'flag for review'.

The online calculator is used in the normal way and can be switched at any time between a basic mode and a scientific mode. You can use your own calculator instead provided that it does not store or display text.

The scratch pad can be used to make notes and do your own rough workings, but nothing written on the scratchpad will actually be marked. You will also be provided with paper if sitting the exam in an exam centre and so you can use this for workings instead - the paper will be collected in at the end of the exam but, again, nothing on this rough paper will be marked. (Note: if you are sitting the exam remotely then paper is not allowed and you can only use the scratchpad.)

The 'flag for review' option enables you to put a mark against a question to enable you to quickly come back to it again later. This is for questions where you are unsure about your answer and want to do more work on it later should there be time.

On the **bottom bar** are the arrows for moving forwards or backwards through the questions. In addition, there is a 'navigator' option which when chosen displays a list of all of the questions enabling you to go straight to a particular question.

You can watch a video illustrating the use of all these features by visiting the following page:

https://www.accaglobal.com/gb/en/student/exam-support-resources/professional-exams-study-resources/strategic-business-reporting/cbe-preparation.html

and clicking on the link to "CBE workspace management video".

3. Section A of the exam

Question 1 requires a mix of calculations and explanations. You should make use of both the spreadsheet and word processor.

In Question 2 it is likely that you will only need to use the word processor.

Details of the functions available such as underlining and 'copy and paste' are in the ACCA booklet.

4. Section B of the exam

This section comprises two 25-mark questions and each question will contain a combination of calculation and written parts. The emphasis will be on explanations.

As with Section A you will be provided with a word processor and a spreadsheet. You may find that you do not need the spreadsheet in one or both of these questions.

5. ACCA Resources

You will find many resources on the ACCA website and the more you refer to the better.

Go first to the following page:

https://www.accaglobal.com/gb/en/student/exam-support-resources/professional-exams-study-resources/strategic-business-reporting/introduction.htmltion to Strategic Business Reporting | ACCA Global

On this page, under the heading "Resources" you will find a link to download "SBR essentials on one page". Clicking on this will download a useful small chart headed up "How to approach

Strategic Business Reporting". One of the headings on this chart is 'Links to support resources' and clicking on each of the items listed in turn will take you to more detail. Each of these 'Key Resources' is worth reading.

In addition, it is important to visit the following page:

https://www.accaglobal.com/gb/en/student/exam-support-resources/professional-exams-study-resources/strategic-business-reporting/cbe-preparation.html

On this page you will find useful information, but also towards the bottom of the page you will find a link to "CBE Guidance Document". This will download a leaflet which details everything about the CBEs including, importantly, a list of the functions and formulae available in the spreadsheet and the word processor (and how to input the formulae in the spreadsheet).

On the same webpage, there is information on how to access the CBE specimen and practice exams - it is essential to use these resources in your exam preparation.

6. Revision Kit Live

On our main Paper SBR page you will find a link to a section called 'Revision Kit Live' in which you will find lectures working through several past exam questions. It includes a lecture working through the whole of question 1 from a computer-based exam, not just explaining the answers but importantly the approach to CBE.

ANSWERS

Chapter 1 – 2

No examples

Chapter 3 – Basic Group Structures

Example Answer 1 – Influence

An associate is usually presumed if ownership of between 20% and 50% is evidenced, so initially it would appear that Vader does not have influence over Ren and is not therefor an associate.

Further investigation into the business relationship reveals a bit more with regards the level of influence that Vader actually exerts, regardless of the percentage ownership. Given that Vader has two seats on the board of directors then this will give them the ability to make themselves heard at board meetings and have influence over the decisions of the other six directors.

Vader should therefore treat Ren as an associated company and equity account for its 19.9% holding from the date when it was acquired.

Example Answer 2 – Basic consolidation

(a) Goodwill

FV of consideration		1,340
NCI (30% x 1,850)		555
Less Net Assets		
Share capital	1000	
RE	450	
Fair value adjustment	400	
		(1,840)
Goodwill		45

(b) Associate

Cost	200
Share of post acquisition profits (6/12 x 25% x 80)	10
Carrying amount in SOFP	210

(c) NCI

At acquisition (from goodwill working)	555
Share of post acquisition profits (30% x 270) (WORKING BELOW)	81
NCI	636

(d) Retained earnings

Parent	1,450
Subsidiary	
Share of post acquisition profits (730% x 270) (WORKING BELOW)	189
Associate	
Share of post acquisition profits (see Associate above)	10
	1,649

WORKING – POST ACQUISITION PROFITS OF SUBSIDIARY

RE at SFP date – in question	800
Less: extra depreciation on fair value adjustment (2/10 x 400)	(80)
	720
RE at at acquisition	(450)
Post- acquisition RE	270

Example Answer 3 – Other components of equity

(a) (i) Goodwill – proportionate share method

FV of consideration	5,400
NCI at acquisition (20% x 3,400)	680
FV of net assets at acquisition (W)	(3,400)
Goodwill at acquisition	2,680

(ii) Goodwill – fair value method

FV of consideration	5,400
NCI at acquisition	700
FV of net assets at acquisition (W)	(3,400)
Goodwill at acquisition	2,700

Group other components of equity

Parent	1,000
Add: P% x Ss post-acq^{n} other comp. equity 80% x (625 - 400)	180
	1,180

Workings

Net assets of subsidiary

	At acquisition
Equity shares	2,000
Ret. earnings	600
Other comp. equity	400
FV – Land	400
	3,400

Example Answer 4 – Group SPLOCI

(a) Group revenue

Parent	1,645
Subsidiary	
6/12 x 1,280	640
Less: inter-company	(20)
	2,265

(b) Goodwill

Consideration	90
NCI	25
Less: Net Assets	(85)
At acquisition	30
Less: Impairment (20%)	(6)
At SOFP date	24

(c) Group admin expenses

Parent	90
Subsidiary	
6/12 x 50	25
Impairment	6
	121

(d) Group OCI

Parent	100
Subsidiary (all post-acquisition)	50
	150

(e) Share of profit of associate

25% x 100	25

(f) NCI

PAT of Maul	
6/12 x 112	56
Less: Impairment	(6)
	50
X 20%	10

Example Answer 5 – Subsidiary impairment

Goodwill

	$'000
FV consideration	20,000
FV NCI	15,000
FV net assets @ acquisition	(25,000)
Goodwill @ acquisition	10,000

Carrying value = FV net assets @ acquistion + post-acquistion profits + goodwill

Carrying value = $25million + $5million + $10million = $40million

FVLCTS = $36million

VIU Recoverable amount (HIGHER) - $38million

Impairment = $40million - $38million = $2million.

Example Answer 6 – Associate impairment

Carrying value = $5million + (25% x £2million) = $5.5million

FVLCTS = 25% x $16million = $4million

VIU = 25% x $20million = $5million

Recoverable amount (HIGHER) = $5million

Impairment = $5.5million - $5million = $0.5million

Carrying value (@31.12.15) = $5.5million - $0.5million = $5million

Chapter 4 – Joint Arrangements (IFRS 11)

Example Answer 1 – Joint operation

Lyon statement of profit or loss for the year-ended 31 December 2015

	$'000	*$'000 40%*
Revenue	30,000	12,000
Costs – direct	(22,000)	(8,800)
Costs – operating	(1,500)	(600)
Depreciation (15,000 / 10 years)	(1,500)	(600)
Profit		2,000

Lyon statement of financial position as at 31 December 2015

	$'000
PPE (6,000 – 600)	5,400
Receivables	12,000
Payables (8,800 + 600)	9,400

Chapter 5 - Changes in group structure

Example Answer 1

Goodwill

	$m
FV consideration	45
FV of existing interest	52
FV NCI @ acquisition	32
FV net assets @ acquisition	(105)
Goodwill @ acquisition	24

A gain of $12 million is also recorded in the group retained earnings, being the increase in fair value of the original investment from $40 million to $52 million.

Example Answer 2

DR	NCI	75
DR	Retained earnings - balancing figure	25
CR	Bank	100

Example Answer 3

DR	Bank	50
CR	NCI	40
CR	Retained earnings – balancing figure	10

Increase in NCI = 10% x (350 +50)

Example Answer 4

		$m
Sale proceeds		120
Fair value of remaining shares		96
Less: Sub sold:		
Net assets	201	
Goodwill	38	
NCI	(53)	
		(186)
		30

Example Answer 5 – Group SFP

Goodwill

HULME		
Cost		75
NCI		40
Less Net Assets		
SC	80	
RE	25	
		(105)
		10
JONES		
Cost		120
NCI		13
Less Net Assets		
SC	75	
RE	35	
		(110)
		23

Difference / Adjustment

HULME	
Cash paid	15
Reduction in NCI	
10/40 x 56	(14)
Adjustment	1 debit
JONES	
Cash received	35
Increase in NCI	
20/10 x 14	(28)
Adjustment	7 credit

Example Answer 6 – Group SPL

NCI = [25% x 146 x 3/12] + [35% x 146 x 9/12] = $47.45 million.

Example Answer 7 – Group SPL

The initial 25% holding would have been treated as an associate and equity accounting used. The statement of financial position would show the investment in associate in non-current assets, shown as the cost plus 25% share of post-acquisition movement in Matthew's retained earnings. The statement of profit or loss would show the share of profit of associate, 25% of Matthew's profit for the year, immediately before profit before tax.

The acquisition of the additional 55% gives control as the parent now owns 80% and the associate becomes a subsidiary and is consolidated. The assets/liabilities and revenue/costs are added together 100% on a line-by-line basis. Goodwill on acquisition will be calculated alongside the non-controlling interest (20%) and group retained earnings for inclusion in the group statement of financial position.

The associate is removed from the accounts at its carrying amount, and the fair value of the shares previously held is included in the goodwill calculation. Any difference between the carrying amount and fair value goes through profit or loss.

The acquisition of the additional 10% to give 90% ownership is a change in ownership. The subsidiary is consolidated as previously, but there is a change in the NCI percentage, which has decreased from 20% to 10%. The difference between the amounts paid and the reduction in the NCI goes through retained earnings.

Chapter 6 – Foreign currency

Example Answer 1

1 December 2015

DR	Purchases	$97,561
CR	Payables	$97,561

$$= \frac{400{,}000 \text{ Dinar}}{4.1} = \$97{,}561$$

31 December 2015

Retranslate the monetary balance (payable) at the closing rate (4.3 Dinar:$1)

$$= \frac{400{,}000 \text{ Dinar}}{4.3} = \$93{,}023$$

Reduction in payables = $97,561 - $93,023 = $4,538

DR	Payables	$4,538
CR	Profit or loss	$4,538

Do not retranslate the non-monetary balance (inventory), and leave it at $97,561 at the reporting date.

10 January 2016

Translate the payment at the exchange rate on the day of the transaction

$$= \frac{400{,}000 \text{ Dinar}}{4.4} = \$90{,}909$$

DR	Payables	$93,023
CR	Bank	$90,909
CR	Profit or loss	$2,114

Example Answer 2

	Historic cost *$m*	*Revaluation model* *$m*	*Revaluation reserve* *$m*
Cost (1.1.11) = 72/3.6	20		
Acc. Depn. (5/25 x $20m)	(4)		
Carrying value (31.12.15)	16	22.1 = 95/4.3	6.1

Example Answer 3

(i) Goodwill

	Dinars m
FV of consideration	760
NCI at acquisition (20% x 500)	100
FV of net assets at acquisition (W2)	(500)
Goodwill at acquisition	360

Dinars 360 million @ 4.3 CR = $83.7 million

Dinars 360 million @ 3.8 OR = $94.7 million

Loss on goodwill = 83.7 – 94.7 = $11.0 million

(ii) Post-acquisition reserves

	Dinars m	*Rate*	*$m*
Non-current assets	500	@ CR	116.3
Current assets	390	@ CR	90.7
Total assets			**207**
Equity share capital	350	@ HR	92.1
Reserves			
- Pre-acquisition	150	@ HR	39.5
- Post-acquisition	130	(β)	15
Non-current liabilities	65	@ CR	15.1
Current liabilities	195	@ CR	45.3
Equity and liabilities			**207**

(iii) NCI

	$m
NCI @ acqⁿ (100 @ 3.8 HR)	26.3
Add: 20% x 15 (ii)	3
	29.3

(iv) Group retained earnings

	$m
100% P	110
Add: 80% x 15 (ii)	12
Less: exchange loss on goodwill	(11)
	111

Example Answer 4 – gain or loss on translation of overseas subsidiary

		$m
Opening net assets = 500 million Dinars		
@ OR (3.8)	131.6	
@ CR (4.3)	116.3	
		(15.3)
Profit for the year = 130 million Dinars		
@ AR (4.0)	32.5	
@ CR (4.3)	30.2	
		(2.3)
Goodwill = 360 million Dinars		
@ OR (3.8)	94.7	
@ CR (4.3)	83.7	
		(11.0)
Translation loss		(28.6)

Any gains or losses on translation of the overseas subsidiary are recognised in other comprehensive income.

Chapter 7 – Group statement of cash flow

Example Answer 1

Non-controlling interest

		B/f	110
Dividend paid (β)	1	Profit	6
C/f	115		
	116		116

Example Answer 2

Associate

B/f	180		
Profit	20	Dividend paid (β)	10
		C/f	190
	200		200

Note

Note from the proforma cash flow in the notes that, as well as including the dividend from the associate as an **investing** cash flow, it is also necessary to deduct the profit of the associate in the **operating** section of the cash flow (to avoid double counting).

Example Answer 3

	2015 $m
Operating activities	
Increase in inventory (W)	58
Increase in receivables (W)	(15)
Increase in payables (W)	15
Investing activities	
Acquisition of subsidiary, net of cash (50 – 5)	(45)

Working capital movement

	Inventory	*Receivables*	*Payables*
Opening	195	109	67
Acquisition/(disposal)	8	6	3
Expected	203	115	70
Closing (actual)	145	130	85
Movement	58↓	15 ↑	15 ↑

Example Answer 4

(i) Dividend received from associate = $30 million

Associate

B/f		190		
Profit	(20% x 200)	40	Dividend paid (β)	30
			C/f	200
		200		200

Or;

Dividend received = P's% x A's dividend paid = 20% x $150 million = $30 million

(ii) Dividend paid to the non-controlling interests = $20 million

(iii) Net cash on acquisition of the subsidiary = $47 million

Cash paid to acquire subsidiary = $50 million

Less: cash in subsidiary = $3 million

Net cash = $47 million

(iv)

	$m
Operating Activities	
Group Profit Before Tax	375
Finance cost	55
Depreciation	130
Impairment	54
Profit on disposal of PPE	(7)
Share of Associates Profit	(40)
Inventory	70
Receivables	(51)
Payables	(139)
Cash generated from operations	447

Workings

Working capital movement

	Inventory	*Receivables*	*Payables*
Opening	580	390	430
Acquisition	20	15	9
Expected	600	405	439
Closing (actual)	530	456	300
Movement	70↓	51↑	139↓

Chapter 8 – Non-current assets

Example Answer 1 – Revaluation increase

SFP	*$'000*	*SPLOCI*	*$'000*
Property, plant and equipment	89,412	Depreciation	5,588
Revaluation reserve	25,412	Gain	27,000

	Historic cost ($'000)	*Revaluation model ($'000)*	*Revaluation reserve ($'000)*
Cost (1.1.12)	80,000		
Acc. Depn. (80,000/20) x 3 years	(12,000)		
Carrying value (31.12.14)	68,000	95,000	27,000
Depreciation (95,000/17)	(4,000)	(5,588)	(1,588)
		89,412	25,412

Example Answer 2 – Revaluation decrease

SFP	*$'000*	*SPLOCI*	*$'000*
Property, plant and equipment	8,000	Depreciation	1,750
		Impairment	400
		Impairment	3,850

	Historic cost ($'000)	*Revaluation model ($'000)*	*Revaluation reserve ($'000)*
Cost (1.1.13)	12,000		
Acc. Depn. (12,000/10) x 2 years	(2,400)		
Carrying value (31.12.14)	9,600	14,000	4,400
Depreciation (14,000/8)	(1,200)	(1,750)	(550)
Carrying value (before)	8,400	12,250	3,850
Impairment	(400)	(4,250)	(3,850)
Carrying value (after)		8,000	Nil

Example Answer 3 – Change in estimate

	SFP *$'000*		*SPLOCI* *$'000*
Property, plant and equipment	14,000	Depreciation	3,500

	$'000
Cost (1.1.12)	25,000
Acc. Dep. (25,000/10) x 3 years	(7,500)
Carrying value (31.12.14)	17,500
Depreciation 17,500/5	(3,500)
	14,000

Example Answer 4 – Specific borrowings

Borrowing costs = $10 million x 5% x 9/12
= $375,000

Example Answer 5 – Grants and depreciable assets

The property, plant and equipment will be capitalised on the statement of financial position as a non-current asset at its cost of $10 million.

It will be depreciated over its 10 year useful life and therefore $1 million of depreciation will be charged through profit or loss each year. The carrying value of the PPE will be reduced by the same amount each year.

The government grant is for a depreciable asset and so the $2 million will be spread over the same life as the PPE.

As Tweddle has met the conditions for the grant the $2 million will be recognised as deferred income on the statement of financial position.

It will be spread/amortised over 10 years and therefore $0.2 million income will be shown in profit or loss each year, with the deferred income being reduced by the same amount each year.

Tweddle will also split the deferred income at the reporting date between current and non-current liabilities.

The statement of cash flows will show a payment to acquire PPE of $10 million and grant income of $2 million in investing activities.

The depreciation and amortisation of government grants are both non-cash items in profit or loss and will need adjusting in operating activities if using the indirect method.

Example Answer 6 – Investment property and change of use

Addlington will treat the property using IAS 16 for the first six-months of the year before applying IAS 40 once the change in use of the property took place.

The property will be depreciated for the first six-months of the year resulting in a depreciation expense through profit or loss of $0.5 million ($20 million/20 years x 6/12), thus reducing the carrying value to $19.5 million ($20 million - $0.5 million).

The property is revalued to its fair value of $21 million on 1 July 2015 under IAS 16, giving a gain through other comprehensive income of $1.5 million ($21 million - $19.5 million).

The property is now classified as investment property and no longer depreciated.

It is revalued to a fair value of $21.6 million at the reporting date with the gain of $0.6 million going through profit or loss.

Chapter 9 – Intangible assets

Example Answer 1 – Intangibles

The purchase of the patent should be capitalised at $15 million and amortised over its useful life.

The $6 million spent on the investigative phase is essentially research and should be expensed through profit or loss as incurred.

The $8 million subsequently spent after completion of the research phase is development expenditure and is capitalised as an intangible non-current asset on the statement of financial position.

It is not yet amortised as the project is not yet complete but an impairment review should be carried out to see if the asset has lost value.

The $1.5 million spent on marketing and training should both be expensed through profit or loss immediately.

Chapter 10 – Impairments

Example Answer 1 – CGU impairment

The plant and equipment is reduced in value to $4 million ($5.2 million - $1.2 million) as it has been specifically impaired following the destruction by fire of some of the equipment.

The goodwill is then fully impaired and written down to a nil carrying value.

The patent it reduced in value to $1.5 million

The remaining impairment is then $3.1 million ($17 million - $9.8 million (recoverable amount of CGU) - $1.2 million (plant & equipment) - $2.4 million (goodwill) - $0.5 million (patent)), which is spread pro-rate over the remaining assets. As the receivables and cash are held at their realisable values they will not be impaired and so the remaining impairment is fully allocated to the buildings.

Chapter 11 – Non-current assets held for sale and discontinued operations

Example Answer 1 – NCA-HFS

Depreciate asset to 30 April. Depreciation is 100 (4/12 x 300). New carrying amount will be $13.9m.

Revalue to fair value. Gain is $1.5m (15.4 – 13.9). Gain to OCI.

Value at lower of carrying amount (15.4) and FVCTS (15.4 – 0.3 = 15.1). Loss of $0.3m to P&L.

Present in SFP as current asset.

Example Answer 2 – Discontinued operations

31 December 2015

The operation is not being sold so cannot be classified as held for sale and neither is it a discontinued operation as it is still operating until 31 March 2016. Angola is firmly committed to the closure but it hasn't taken place and so is included in continuing operations. A disclosure in the notes can be made of the intention to close the operation in the following year.

31 December 2016

The operation is now classified as a discontinued operation as it has now ceased operating.

Chapter 12 - Employee Benefits

Example Answer 1 – Defined benefit scheme

Statement of financial position (extract)

	$m
Fair value of scheme assets	66
Fair value of scheme liabilities	(75)
Net pension asset/(liability)	(13)

Statement of profit or loss and other comprehensive income (extract)

	$m
Profit or loss	
Operating costs	
Current service costs	(9)
Past service costs	(8)
Financing costs	
Interest expense (W)	(3.2)
Return on investment (W)	3
Other comprehensive income	
Re-measurement gain (W)	7.2

Workings

Assets	*$m*	Liabilities	*$m*
Opening	60	Opening	64
Return on investment (60 x 5%)	3	Interest (64 x 5%)	3.2
Contributions paid in	5	Service costs (9 + 8)	17
Benefits paid out	(6)	Benefits paid out	(6)
Expected	62	Expected	78.2
Re-measurement component (β)	4	Re-measurement component (β)	(3.2)
Closing (per actuary)	66	Closing (per actuary)	75

Note that the net interest cost is (usually) calculated by multiplying the interest rate given by the **opening** balance on the pension asset / liability.

Example Answer 2 – Curtailment

The re-organistion has led to redundancies and therefore a significant number of employees will have left the scheme as they are no longer entitled to earn nay future pension benefits.

The net liability on the statement of financial position will be $7 million ($48 million - $55 million) and a gain will be shown through profit or loss of $5 million, being the reduction in the liability ($60 million - $55 million).

Example Answer 3 – Asset ceiling

The asset ceiling is the present value of the reductions in future contributions, above which the value of the net pension asset cannot be recognised above.

The pension asset is currently above the asset ceiling so must be reduce to $26 million and the reduction in value of $4 million ($30 million - $26 million) shown as a loss through OCI.

Chapter 13 – Share based payments

Example Answer 1 – Fair value equity settled (services)

Statement of financial position (extract)

	31 Dec'15	*31 Dec'16*	*31 Dec'17*
Other components of equity (W)	$800,000	$1,600,000	$2,400,000

Statement of profit or loss (extract)

	31 Dec'15	*31 Dec'16*	*31 Dec'17*
Expense (= movement)	$800,000	$800,000	$800,000

Workings

31 December 2015

Obligation = 10,000 options x 20 employees x $12 x $\frac{1}{3}$

= $800,000

31 December 2016

Obligation = 10,000 options x 20 employees x $12 x $\frac{2}{3}$

= $1,600,000

31 December 2017

Obligation = 10,000 options x 20 employees x $12 x $\frac{3}{3}$

= $2,400,000

Example Answer 2 – Options to be exercised (equity settled)

Statement of financial position (extract)

	31 Dec'14	*31 Dec'15*
Other components of equity (W)	$2,400,000	$7,200,000

Statement of profit or loss (extract)

	31 Dec'14	*31 Dec'15*
Expense (= movement)	$2,400,000	$4,800,000

Workings

31 December 2014

Obligation = 20,000 options x (10 – 4) employees x $60 x $\frac{1}{3}$

= $2,400,000

31 December 2015

Obligation = 20,000 options x (10 – 1) employees x $60 x $\frac{2}{3}$

= $7,200,000

Example Answer 3 – Fair value equity settled (goods)

The transaction involves an equity settled share based payment for goods as the supplier has the right to receive shares in Caerphilly in return for the transfer of goods.

As it is an equity settled share based payment the fair value of the goods at $10 million should be used to record the transaction.

DR	Purchases/inventory	$10 million
CR	Other components of equity	$10 million

Example Answer 4 – Fair value cash settled

Statement of financial position (extract)

	31 Dec'15	*31 Dec'16*	*31 Dec'17*
Liability (W)	$900,000	$1,840,000	$2,840,000

Statement of profit or loss (extract)

	31 Dec'15	*31 Dec'16*	*31 Dec'17*
Expense (= movement)	$900,000	$940,000	$1,000,000

Workings

31 December 2015

Obligation = 10,000 options x 20 employees x $13.50 x $\frac{1}{3}$

= $900,000

31 December 2016

Obligation = 10,000 options x 20 employees x $13.80 x $\frac{2}{3}$

= $1,840,000

31 December 2017

Obligation = 10,000 options x 20 employees x $14.20 x $\frac{3}{3}$

= $2,840,000

Example Answer 5 – Options to be exercised (cash settled)

Statement of financial position (extract)

	31 Dec'14	*31 Dec'15*
Liability (W)	$3,200,000	$8,000,000

Statement of profit or loss (extract)

	31 Dec'14	*31 Dec'15*
Expense (= movement)	$3,200,000	$4,800,000

Workings

31 December 2014

Obligation = 20,000 options x (10 – 4) employees x $80 x $\frac{1}{3}$

= $3,200,000

31 December 2015

Obligation = 20,000 options x (10 – 2) employees x $75 x $\frac{2}{3}$

= $8,000,000

Example Answer 6 – Vesting conditions

The scheme contains both market based and non-market based vesting conditions.

The market based condition where the share price needs to be $15 at the vesting date is ignored over the vesting period. It is only taken into consideration on 31 December 2017 when the condition is either fulfilled or not fulfilled.

The non-market based vesting condition is accounted for over the vesting period as normal. The fair value at the grant date is therefore spread over the three year vesting period.

The obligation at 31 December is $100,000 (=5,000 options x 5 employees x $12 x 1/3) so therefore an equity balance of $100,000 will be shown on the statement of financial position.

As it is the first year of the scheme the statement of profit or loss will be shown and expense for the same amount.

Chapter 14 – Financial instruments

Example Answer 1 – Financial assets

1. The investment in shares is initially recognised at $500,000 on the statement of financial position as an asset.
   The transaction costs are recognised immediately through profit or loss as the shares are classified as fair value through profit or loss.

   At the reporting date the shares are re-measured to their fair value of $350,000 on the statement of financial position.

   A loss on the investment is recognised through profit or loss of $150,000.

2. The investment in shares is initially recognised at $540,000 on the statement of financial position as an asset.
   The transaction costs are included in the value of the asset as it is held strategically for the long-term and therefore classified as fair value through other comprehensive income.

   At the reporting date the shares are re-measured to fair value of $620,000 on the statement of financial position.

   The gain on the investment of $80,000 is shown through other comprehensive income.

   On disposal of the shares a gain of $30,000 is recognised through OCI.

3. The investment in debt is classified as amortised cost as there are contractual coupon interest receipts each year and the intent is to hold the asset until all the cash has been collected.
   The investment in debt is initially measured at $980,000 on the statement of financial position.

   The effective rate of interest is used to calculate the interest income each year. In the first year the interest income is $55,958 ($980,000 x 5.71%) and is recognised through profit or loss.

   The cash receipts of $40,000 are used to reduce the value of the investment on the statement of financial position.

   The investment in debt is held at $995,958 at the reporting date on the statement of financial position.

Example Answer 2 – Financial liabilities

SPL

	Year 1	*Year 2*	*Year 3*	*Year 4*
Finance cost	87	89	91	93

SFP

	Year 1	*Year 2*	*Year 3*	*Year 4*
2% debentures (W)	1,947	1,996	2,047	-

Working

Year	*B/f*	*Interest (4.58%)*	*Cash*	*C/f*
1	1,900	87	(40)	1,947
2	1,947	89	(40)	1,996
3	1,996	91	(40)	2,047
4	2,047	93	(2,140)	-

Example Answer 3 – Convertible debentures

Alice is required to account for the convertible debentures on initial recognition based on substance and using split equity accounting.

The net proceeds are recorded at $99 million ($100 million less $1 million issue costs).

The liability is calculated on the assumption that there is no conversion option on the debt, so essentially treated as a 100% loan redeem for cash. The initial liability is recognised at the present value of the future cash flows, discounted at the rate of interest on similar debt without the conversion option. This gives a figure of $94.8 million (see working below).

The difference between the liability and the net proceeds is recognised within equity at $5.2 million.

The issues costs will be split between the liability and equity in proportion to the weighting of the liability and equity as follows:

Liability = 94.8 – (0.948 x 1) = 93.9

Equity = 5.2 – (0.052 x 1) = 5.15

The subsequent accounting treatment of the debt is at amortised cost using the effective rate of 6.34% to calculate the effective interest, whilst the equity balance is not adjusted until conversion takes place in the future.

Working

Year	*Cash flow* ($m)	*DF* (@ 6%)	*PV* ($m)
1	4 (4% coupon x $100 million (par))	0.943	3.8
2	4	0.890	3.6
3	104 ($4m plus $100 million (par at redemption)	0.840	87.4
			94.8
			=$94.8 million

Chapter 15 – Fair Value (IFRS 13)

No examples

Chapter 16 – Operating segments

Example Answer 1 – Operating segments

An operating segment is one whose results are regularly reviewed by the chief operating decision maker (CODM). The three segments reviewed by the CODM are therefore three operating segments.

Two or more operating segments may be combined if they have similar economic characteristics. So to combine the domestic operations and the international operations the two segments would need to have similar levels of risk.

The biggest risk that is faced by Gulf within the two segments is the price risk. The revenue from the domestic railways is regulated by the transport authority, so is subject to a different risk from the international railways where it is determined by Gulf itself.

The other risk is from the offering of the contracts. The domestic railway contracts are awarded from the transport authority whereas the international railway contracts are not awarded by any authority and so both are subject to different levels of risk.

The operating segment disclosure note should therefore disclose the three segments separately within the notes to the accounts.

Chapter 17 – Revenue from contracts with customers (IFRS 15)

Answer to example 1 – Transaction price

The three-year interest-free credit period suggests that the $10,000 selling price includes a significant financing component.

The selling price is therefore discounted to present value based on a discount rate that reflects the credit characteristics of the party (customer) receiving the financing i.e. 5%.

Therefore the transaction price is $10,000/(1.05)3 = $10,000 x 0.8638 = $8,638.

Answer to example 2 – Allocation of price

The performance obligations and allocation of total price are as follows:

Provision of home cinema system (9,000/11,000 × $10,000) = $8,182

Provision of maintenance contract (2,000/11,000 × $10,000) = $1,818

Answer to example 3 – IFRS 15 (1)

1. Identify the contract
   - Signed agreement
2. Identify the separate performance obligations
   - Sale of handset
   - Provision of calls and data service
3. Determine the transaction price
   - $540 = $45 x 12 months
4. Allocate transaction price to performance obligations
   - Standalone prices (using Vodaphone)
   - $720 (= $480 + (12 months x $20)
   - Handset = 480/720 x 540 = $360
   - Calls and data = 240/720 x 540 = $180
5. Recognise revenue as each performance obligation is satisfied
   - Handset (goods) = at delivery
   - Calls and data (services) = over 12 months

Answer to example 4 – IFRS 15 (2)

1. Identify the contract
   - Signed agreement
2. Identify the separate performance obligations
   - Supply and installation service
   - Technical support
3. Determine the transaction price
   - Combined contract price = $1,600
4. Allocate transaction price to performance obligations
   - Standalone price(supply and installation) = $1,500
   - Standalone price (technical support) = $500
   - Supply and installation = 1,500/2,000 x 1,600 = $1,200
   - Technical support = 500/2,000 x 540 = $400
5. Recognise revenue as each performance obligation is satisfied
   - Supply and installation = on installation (1 July 20X7)
   - Technical support = over two years (1 July 20X7 to 30 June 20X9)

SFP (extract)

	$
Non-current liabilities	
Deferred income	100
Current liabilities	
Deferred income	200
= 12/24 x 400	

SPL (extract)

	$
Revenue	1,300
= 1,200 + (6/24 x 400)	

Answer 5 – Performance obligations over time and the statement of profit or loss (1)

Recognise revenue based on inputs.

Revenue = Contract value x Costs to date / Total costs = 45 x 20/32 = $28.1m

Chapter 18 – Leases

Answer 1 – Low-value assets

An expense of $1,500 would be recognised through profit or loss for each of the four year lease. At the end of year one an accrual of $1,500 would be recognised on the statement of financial position of which $500 would be released over the remaining three years of the lease.

$$\text{Expense (p.a.)} = \frac{\$2{,}000 \times 3}{4} = \$1{,}500$$

Answer 2 – Identifying a lease

1. The identified asset is the specific rail cars in the contract to which the supplier does not have substantive substitution rights (unless for repairs or maintenance). The customer has exclusive use of the rail cars so has the right to all the economic benefits. The contract therefor contains a lease of the rail cars.

2. There is no identified asset as the supplier can use any rail car as long as it meets the specific type as designated in the contract, which means that the supplier has substantive substitution rights. As the supplier can choose which rail car to use out of a fleet then they have substantially all of the economic benefit of the rail car and hence there is no lease within the contract.

Answer 3 – Lease and non-lease components

Pear will allocate $90,476 as the lease rental and apply this using IFRS 16 (right-of-use asset and lease liability), whilst the $9,524 will be recognised through profit or loss each year.

	Stand-alone price		*Allocated*
	$		*$*
Machinery (lease)	95,000	90.48% (=95/105)	90,476
Maintenance (non-lease)	10,000	9.52% (10/105)	9,524
Total	105,000	100.0%	100,000

Answer 4 – Lessee accounting

Initial recognition

1. Record the right of use asset and lease liability

DR	Right-of-use asset	$22,730
CR	Lease liability	$22,730

2. Record the initial direct costs

DR	Right-of-use asset	$1,000
CR	Cash	$1,000

3. Record the incentive payments received

DR	Cash	$500
CR	Right-of-use asset	$500

Right-of-use asset = 22,730 + 1,000 – 500 = 23,230

Subsequent measurement

Depreciate the asset over the earlier lease term of five years.

$$\text{Expense (p.a.)} = \frac{\$23,230}{5} = \$4,646$$

Record finance lease payments and interest using the rate implicit in the lease

Year	*B/f*	*Payment*	*Capital balance*	*Finance cost (5%)*	*C/f*
1	22,730	-5,000	17,730	887	18,617
2	18,617	-5,000	13,617	681	14,298
3	14,298	-5,000	9,298	465	9,763
4	9,763	-5,000	4,763	237	5,000
5	5,000	-5,000	-	-	-

Answer 5 - Lessor accounting

Income of $1,500 would be recognised through profit or loss for each of the four year lease. At the end of year one, accrued income of $1,500 would be recognised on the statement of financial position of which $500 would be released over the remaining three years of the lease.

Answer 6 – Lessor accounting

Net investment in the lease = $23,484 (W)

Year		*DF 4%*	*PV*
0	5,000	1	5,000
1	5,000	0.962	4,810
2	5,000	0.925	4,625
3	5,000	0.889	4,445
4	5,000	0.855	4,275
5	400	0.822	329
			23,484

Answer 7 – Sale and leaseback

(i) Transfer of asset is not a sale

Seller	*Lessor*
◉ Continue to recognise the asset @ $8.4 million and depreciate.	◉ Do not recognise the asset as it has not been sold to the buyer.
◉ Recognise a financial liability @ transfer proceeds of $10 million.	◉ Recognise a financial asset @ transfer proceeds of $10 million.

(ii) Transfer of asset is sale

Seller	*Lessor*
◉ Derecognise the asset @ $8.4 million[1]	◉ Recognise purchase of the asset @ $10 million (fair value = proceeds)
◉ Recognise lease liability @ PV of lease rentals[2]	◉ Apply lessor accounting
◉ Recognise a right-of-use asset, as a proportion of the previous carrying value of underlying asset [3]	
◉ Gain/loss on rights transferred [4]	

DR Bank	$10,000,000	
DR Right of use asset[3] (W2)	$6,486,257	
CR Lease liability[2] (W1)		$7,721,735
CR PPE – Building[1]		$8,400,000
CR Gain on transfer[4] (balancing figure)		$364,522

(W1) Lease liability = PV of lease rentals at rate implicit in the lease = $1 million x $AF_{1\text{-}10@5\%}$

Lease a = $1 million x 7.722 = $7,721,735

(W2)	*$*		*$*
Right-of-use retained	7,721,735	77.22%	6,486,257
Rights transferred	2,278,265	22.78%	1,913,743
Total	10,000,000	100.0%	8,400,000

Chapter 19 Inventory

Example Answer 1– Inventory

	$
Selling price	1,450
Less: selling costs	(10)
NRV	1,440
Less: conversion costs	(500)
NRV (1st stage)	940

Write down:

		$m
Finished goods	200,000 units x (1,500 – 1,440)	12
First stage of production	100,000 units (1,000 – 940)	6

Chapter 20 – Deferred tax

Example Answer 1 – Accelerated capital allowances

1. Calculate the temporary difference

	Year 1	Year 2	Year 3
	$	$	$
Carrying value	130,000	110,000	90,000
Tax base	112,500	84,375	63,281
Temporary difference	17,500	25,625	26,719

2. Calculate the deferred tax position

	Year 1	Year 2	Year 3
	$	$	$
Temporary difference	17,500	25,625	26,719
Deferred tax position @20%	3,500	5,125	5,344

3. Deferred tax asset/liability?

	Year 1	Year 2	Year 3
	$	$	$
	CV > TB	CV > TB	CV > TB
	DT Liability	DT Liability	DT Liability
	3,500	5,125	5,344

4. Movement in opening and closing position

	Year 1	Year 2	Year 3
	$	$	$
Closing position	3,500	5,125	5,344
Opening position	Nil	3,500	5,125
Movement to P&L	3,500	1,625	219
	↑ Liability	↑ Liability	↑ Liability

Example Answer 2 – Share based payments

	Year 1
	$
Carrying value (1,000 SBP x 100 employees x $1.60 (intrinsic) x ¼)	(40,000)
Tax base	Nil
Temporary difference	40,000
Deferred tax position @20%	8,000 DT Asset (CV < TB)

Example Answer 3 – Revaluations

There is a gain on revaluation at the year-end of $320,000 ($800,000 - $480,000) that is shown through other comprehensive income.

The deferred tax is calculated in the standard fashion but the carrying value is based upon the revalued amount.

	Year 1
	$
Carrying value (revalued amount)	800,000
Tax base	420,000
Temporary difference	380,000
Deferred tax position @20%	76,000 Liability (CV > TB)

The deferred tax liability must be recorded at $76,000 at the end of the first year but careful consideration must be given to the movement in the deferred tax liability as t is higher than what it is expected to be given the asset was revalued.

DR	Profit or loss (β)	12,000
DR	Other comprehensive income ($320,000 gain on revaluation x 20%)	64,000
CR	Deferred tax liability	76,000

Chapter 21 – Provisions, contingent liabilities and contingent assets

Example Answer 1 – Provisions and contingent liabilities

York should record a provision for $15 million to cover all of the three major projects that have environmental clean-up costs.

York has created a constructive obligation to clean-up any environmental damage, regardless of whether there is a law enforcing it, as it has a clear communicated policy on its website and in its annual report.

If York had not created the constructive obligation then it would only have provided for the $4 million as here there is a law enforced, creating a legal obligation.