
Answers

1 Consolidated statement of financial position of Alpha at 31 December 20X9
 [Note: all figures below in \$'000]

	\$'000
Assets	
Non-current assets	
Property, plant and equipment (350,000 + 225,000 + 12,000 (W1))	587,000
Goodwill (W2)	76,000
Investment in associate (W5)	45,400
Financial assets	36,000
	744,400
Current assets	
Inventories (105,000 + 80,000 – 5,000 (W4))	180,000
Trade receivables (95,000 + 70,000 – 10,000 (cash in transit))	155,000
Cash and cash equivalents (30,000 + 35,000 + 10,000 (cash in transit))	75,000
	410,000
Total assets	1,154,400
Equity and liabilities	
Equity attributable to equity holders of the parent	
Share capital (\$1 shares)	200,000
Retained earnings (W4)	204,700
Other components of equity (W8)	107,000
	511,700
Non-controlling interest (W3)	50,400
Total equity	562,100
Non-current liabilities	
Long-term borrowings (W7)	192,300
Deferred tax (110,000 + 25,000)	135,000
Total non-current liabilities	327,300
Current liabilities	
Trade and other payables (100,000 + 90,000)	190,000
Current tax payable (50,000 + 25,000)	75,000
Total current liabilities	265,000
Total liabilities	558,200
Total equity and liabilities	1,154,400

Working 1 – Net assets table for Beta

	1 January 20X8	31 December 20X9
	\$'000	\$'000
Share capital	100,000	100,000
Other components of equity	55,000	55,000
Retained earnings:		
Per financial statements of Beta	30,000	65,000
Fair value adjustments:		
Property, plant and equipment (post-acquisition additional depreciation 20,000/5 years x 2 = 8,000)	20,000	12,000
Contingent liability	(25,000)	–
Net assets for the consolidation	180,000	232,000
Increase in net assets (232,000 – 180,000) = 52,000		

Working 2 – Goodwill on acquisition of Beta

	\$'000
Fair value of shares issued (80,000 x ½ x \$5.40)	216,000
Non-controlling interest at date of acquisition (20,000 x \$2.00)	40,000
Net assets at date of acquisition (W1)	(180,000)
Goodwill at 1 January 20X9	76,000

Working 3 – Non-controlling interest in Beta

	\$'000
At date of acquisition (W2)	40,000
20% of post-acquisition increase in net assets (20% x 52,000 (W1))	10,400
	<u>50,400</u>

Working 4 – Retained earnings

	\$'000
Alpha – per draft SOFP	170,000
80% of post acquisition share of Beta (80% x 52,000 (W1))	41,600
Unrealised profit on sales to Beta (15,000 x 50/150)	(5,000)
Acquisition costs of Beta	(2,000)
Share of profits of Gamma (W5)	4,400
Finance cost of convertible loan (W7)	(9,300)
Gain on financial asset portfolio (W9)	5,000
	<u>204,700</u>

Working 5 – Investment in Gamma

	\$'000
Cost of investment	41,000
Share of post-acquisition profits (W6)	4,400
	<u>45,400</u>

Working 6 – Share of post-acquisition profits of Gamma

	\$'000
Per Gamma's own financial statements – 40% (35,000 – 20,000)	6,000
Unrealised profit in inventory – 40% x 12,000 x 50/150	(1,600)
	<u>4,400</u>

Working 7 – Long-term borrowings

	\$'000
Loan element of convertible loan (150,000 x \$0.62)	93,000
Finance cost (93,000 x 10%)	9,300
Alpha's remaining long-term borrowings (140,000 – 100,000)	40,000
Beta's long-term borrowings	50,000
	<u>192,300</u>

Working 8 – Other components of equity

	\$'000
Alpha – per draft financial statements	100,000
Equity element of convertible loan (100,000 – 93,000 (W7))	7,000
	<u>107,000</u>

Working 9 – Gain on financial asset portfolio

	\$'000
Carrying amount per draft financial statements of Alpha	290,000
Carrying amounts of investments in:	
Beta (216,000 (W3) + 2,000)	(218,000)
Gamma (W5)	(41,000)
	<u>31,000</u>
Carrying amount of financial asset portfolio per draft financial statements of Alpha	31,000
Gain on revaluation of the portfolio (balancing figure)	5,000
	<u>36,000</u>

2 (a) Attachment 1 to the email

The relevant standard is IAS 19 – *Employee Benefits*. IAS 19 states that in the case of a defined benefit retirement plan, the contributing company should recognise the net defined benefit obligation/asset (pension liability less pension asset) in its own statement of financial position. Therefore the treatment of this amount in the statement of financial position at 30 September 20X8 is correct but will need to be updated to reflect the position at 30 September 20X9 and cannot be ignored per the FD's suggestion. The net defined benefit obligation will be \$9 million (\$67 million – \$58 million).

IAS 19 states that the current service cost (the increase in the defined benefit pension liability as a result of service in the current reporting period) should be recognised as an operating expense in the statement of profit or loss for the year. In the case of Delta, this expense is \$12.5 million and not the \$5m presently charged to PL.

IAS 19 further requires that an interest charge on the net pension liability be shown as a finance cost in the statement of profit or loss. This charge should be based upon the opening net defined benefit liability using the rate of return on high quality corporate bonds at the start of the reporting period.

In this case, the finance cost for the year ended 30 September 20X9 will be \$480,000 (\$6 million x 8%).

The contributions payable by Delta to the defined benefit plan will be invested by the plan managers as plan assets and in effect reduce the closing amount of the net defined benefit liability. It cannot be used simply to reduce the liability as suggested by the FD or indeed expensed to profit or loss.

The benefits paid to retired plan members will reduce both the overall defined benefit liability and the assets of the plan, so will have no impact on the overall financial position of the net defined benefit obligation shown on Delta's statement of financial position.

Any difference between the opening and closing net liability and the impact of the transactions already described will be treated as an actuarial gain or loss. Any such gain or loss will be recognised in other comprehensive income.

In this case the actuarial loss will be \$1.02 million (W1).

Attachment 2 to the email

Accounting for inventories is governed by IAS 2 – *Inventories*. IAS 2 states that inventories should be measured at the lower of cost and net realisable value.

IAS 2 states that the net realisable value of inventories should be determined for each category of inventory rather than for inventory as a whole. Therefore the fact that the net realisable value of product Y items is in excess of their cost is irrelevant in determining the net realisable of product X items.

The reduction in the selling price of product X items in October 20X9 is an event after the reporting period as defined in IAS 10 – *Events after the Reporting Period* – because it occurred after the reporting date but before the financial statements were authorised for issue.

The entry is an adjusting event because it provided more information about the likely sales proceeds (and therefore net realisable value) of inventory at the reporting date.

The net realisable value of an item of inventory is the anticipated sales proceeds net of selling costs.

Therefore the net realisable value of the product X items is \$17.2 million (10 million x \$1.72 [\$1.80 – \$0.08]). This amount should be shown as a current asset in the statement of financial position at 30 September 20X9. This requires a write down through profit of loss of \$2.8 million (\$20 million cost less NRV \$17.2 million).

No adjustment is needed to product Y as cost (\$3) is lower than NRV (\$3.50).

(b) Earnings (W2) = \$31.22 million

Number = 80 million x 9/12 + 100 million x 3/12 = 85 million

So EPS equals **36.7 cents** (\$31.22 million/85 million shares).

W1 – Spreadsheet workings: actuarial loss for the year ended 30 September 20X9

	\$'000
Opening net liability	6,000
Current service cost	12,500
Interest cost on net liability	480
Contributions paid	(11,000)
	<u>7,980</u>
Actuarial loss (balancing figure)	1,020
Closing net liability (67,000 – 58,000)	<u>9,000</u>

Alternative working for separate obligation/asset column

	<i>Asset \$'000</i>	<i>Obligation \$'000</i>
<i>Opening</i>	54,000	60,000
<i>Current service cost</i>		12,500
<i>Contributions paid</i>	11,000	
<i>Benefits paid</i>	(7,000)	(7,000)
<i>Interest</i>	4,320	4,800
	<hr/>	<hr/>
	62,320	70,300
<i>Remeasurement loss/actuarial gain</i>	(4,320)	3,300
	<hr/>	<hr/>
<i>Closing</i>	58,000	67,000

Net to OCI (4,320 – 3,300) = 1,020

W2 – Spreadsheet workings: earnings for EPS purposes for the year ended 30 September 20X9

	\$'000
Profits per draft financial statements	42,000
<i>Add: contributions incorrectly charged to P/L</i>	5,000
<i>Deduct: current service cost</i>	(12,500)
<i>Deduct: interest cost on net defined benefit liability</i>	(480)
<i>Deduct: actuarial loss (charged to OCI)</i>	nil
<i>Deduct: write down of inventory (20,000 – 17,200)</i>	(2,800)
	<hr/>
Corrected profits for EPS purposes	31,220

(c) Ethical issue – Email from FD

You are in danger of breaching the fundamental ethical principle of integrity. The FD has suggested that you collude in the reporting an inflated profit figure and, as a result, share in a profit related bonus (*candidates who referred to a self-interest threat here received appropriate credit*).

You could also be said to be potentially breaching the fundamental principle of integrity in these circumstances in the sense that colluding in the reporting of an inflated profit figure would present a misleading picture to the shareholders of Delta.

You face a danger of breaching the principle of objectivity because of the way the FD has linked your complying with these instructions to your upcoming staff appraisal (*candidates who referred to an intimidation threat received appropriate credit*).

You also may be breaching the fundamental ethical principle of professional competence and due care. The treatments suggested by the FD are clearly inappropriate and not in compliance with IFRS Accounting Standards. Were you to implement them, you would be in breach of your professional duty to conduct yourself in a competent manner.

3 Exhibit 1 – Memorandum

To: Trainee accountant

From: Financial controller

- (i) IAS 12 – *Income Taxes* requires us to compute temporary differences for **each** asset and liability. A temporary difference is the difference between the **carrying amount** of an asset or liability and its **tax base**.

The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

If the temporary difference is such that the subsequent settlement of the relevant asset or liability will generate taxable amounts, then the temporary difference is a taxable temporary difference.

If the temporary difference is such that the subsequent settlement of the relevant asset or liability will result in an allowable deduction for tax purposes, then the temporary difference is a deductible temporary difference.

- (ii) Deferred tax liabilities or assets should be measured by multiplying the relevant temporary difference by the **rate of corporate income tax which is expected to apply** when the relevant temporary difference generates taxable income or qualifies for a tax deduction. This rate should be computed with reference to **legislation which has been enacted or substantively enacted by the end of the reporting period**.

- (iii) With a very limited number of exceptions, deferred tax liabilities should be recognised on **all taxable temporary differences**.

Deferred tax assets should be recognised in respect of deductible temporary differences **to the extent that it is probable that taxable profits will be available against which the deductible temporary difference can be utilised**.

- (iv) Deferred tax liabilities and assets can be offset in the statement of financial position provided the relevant temporary differences relate to the same tax jurisdiction and the reporting entity intends to settle the relevant taxable amounts on a net basis.

- (v) The movement in a relevant deferred tax liability or asset from one reporting period to another would normally result in an **adjustment to the income tax charge in the statement of profit or loss**. However, if the movement in the relevant deferred

tax amount was as a result of a transaction which is recognised directly in other comprehensive income (for example, most revaluations of property, plant and equipment), then the deferred tax consequences of the transaction would be recognised in other comprehensive income also.

Exhibit 2 – Transactions

Transaction (a)

The carrying amount of the asset on 30 June 20X5 is \$36 million (\$60 million x 3/5).

The tax base of the asset at 30 June 20X5 is \$15 million (\$60 million – \$30 million – \$15 million).

Therefore the **taxable** temporary difference is **\$21 million** (\$36 million – \$15 million) and the relevant deferred tax liability is **\$4.2 million** (\$21 million x 20%).

The carrying amount of the asset on 30 June 20X4 would have been **\$48 million** (\$60 million X 4/5). Its tax base at that date would have been **\$30 million** (\$60 million – \$30 million).

Therefore the taxable temporary difference on 30 June 20X4 would have been **\$18 million** (\$48 million – \$30 million) and the relevant deferred tax liability would have been **\$3.6 million** (\$18 million x 20%).

The increase in the deferred tax liability of \$0.6 million (\$4.2 million – \$3.6 million) will be charged to profit or loss.

Transaction (b)

Under the principles of IFRS 9 – *Financial Instruments* – the interest free loan would have incurred a finance cost of **\$4 million** (\$40 million x 10%). This means that the carrying amount of the loan liability at 30 June 20X5 will be **\$44 million** (\$40 million + \$4 million).

The tax base of the loan will be \$40 million as the entire interest is tax deductible but only when the loan is repaid in 20X8.

Therefore the **deductible** temporary difference will be **\$4 million** (\$44 million – \$40 million) and the relevant potential deferred tax asset **\$0.8 million** (\$4 million x 20%). This asset **can be recognised because it is anticipated that Epsilon will generate sufficient taxable income in future periods to offset the potential future tax deduction.**

Transaction (c)

Under the principles of IAS 36 – *Impairment of Assets* – the goodwill on acquisition of Fred will be reviewed for impairment as **part of the overall cash-generating unit (CGU)**. The carrying amount of the CGU (including goodwill) will be **\$120 million** (\$100 million + \$20 million).

An impairment review involves comparing the carrying amount of the unit with its recoverable amount. Recoverable amount is the **higher of value-in-use and fair value less costs of disposal.**

In this case, the recoverable amount of the CGU is **\$105 million**. This means that the unit has suffered impairment of **\$15 million** (\$120 million – \$105 million).

The impairment loss of \$15 million will reduce the carrying amount of goodwill in Epsilon's consolidated financial statements. IAS 12 prohibits the recognition of deferred tax on the initial recognition and subsequent impairment of goodwill and therefore there is no deferred tax consequence arising from the goodwill impairment.

Overall presentation

The net deferred tax liability at 30 June 20X5 will be **\$3.4 million** (\$4.2 million – \$0.8 million). Offsetting of deferred tax liabilities and assets is justified because they relate to the **same** tax jurisdiction. The net liability will be shown as a non-current liability in the statement of financial position at 30 June 20X5.

The opening deferred tax position regarding these transactions would have been a liability of **\$3.6 million** (see above). Therefore the reduction in the overall liability over the year will be **\$0.2 million** (\$3.6 million – \$3.4 million). This amount will be shown as a **reduction in the tax charge in the statement of profit or loss** (since all the transactions which have generated these temporary differences affect profit or loss).

Tabular working – Deferred tax position at 30 June 20X5 and PL movement

Item	Carrying amount \$'000	Tax base \$'000	Taxable/(deductible) temporary difference \$'000	Deferred tax liability/(asset) \$'000
Machine – at 30 June 20X5	36,000	(15,000)	21,000	4,200
Loan – at 30 June 20X5	(44,000)	40,000	(4,000)	(800)
Overall position at 30 June 20X5				3,400
Machine – at 30 June 20X4	48,000	(30,000)	18,000	3,600

The credit to profit or loss in the year is the difference between the closing liability (\$3.4 million) and the opening liability (\$3.6 million). This difference is \$0.2 million.

4 Exhibit 1 – Fair values

The use (or otherwise) of fair value as a measurement basis is covered by specific IFRS Accounting Standards. Overall, the requirements of specific IFRS Accounting Standards lead to a mixed measurement model being used.

The accounting standard which is relevant to the use of fair values is **IFRS 13 – Fair Value Measurement**. As its title implies, IFRS13 deals with the **measurement of fair value rather than when** fair value should actually be used as a measurement basis.

IFRS 13 states that the fair value of an asset is the **amount which could be expected to be received from its disposal in an orderly transaction between market participants**. Transaction costs are **not** deducted in computing fair value.

Therefore fair value is an exit measure rather than an entry measure. **In the case of shares in a listed entity, for which a 'buy' and a 'sell' price is quoted, it is the 'sell price' which is relevant for fair value measurement.**

Where possible, fair value should be based on **observable** market prices. If there is **more than one** 'market' on which the asset is traded (which could easily be the case for equity shares in a listed entity), then fair value measurement should be based on the **principal market** in which the asset is traded.

Where no specific market prices are available for an individual asset, then IFRS 13 requires that fair values are **estimated** using a range of possible approaches. In the case of shares in an unquoted entity, these **could include** basing fair value on the market prices of the shares of a similar listed entity, discounted for relative lack of marketability, or basing fair value on the projected future earnings, discounted at an appropriate discount rate.

Exhibit 2 – Properties

The fair value of a property would be computed using the **principles set out in IFRS 13**.

In the specific case of properties, fair values could almost certainly be estimated based on the market prices of similar properties which had recently been sold on the open market in the same location.

This estimate would need to reflect **alternative uses** to which the property could be put compared with its current usage. This is **because IFRS 13 requires us to base fair value measurement on the highest and best use** to which the property could be put and which 'market participants' would consider in making a decision to acquire the property.

There are **two separate** IFRS Accounting Standards dealing with the recognition and measurement of properties. These are **IAS 40 – Investment Properties** and **IAS 16 – Property, Plant and Equipment (PPE)**.

IAS 40 **defines** an investment property as one which is held to earn rentals and/or capital appreciation. The properties which we rent out clearly meet this definition.

IAS 40 requires that investment properties are measured using **either** the cost model **or** the fair value model. It **appears** that Omega uses the fair value model to measure its investment properties.

Under the fair value model as set out in IAS 40, investment properties are revalued **annually** to fair value, with gains or losses recognised in **profit or loss**.

Owner occupied properties are dealt with under IAS 16. IAS 16 states that a particular class of PPE is measured using **either** the cost model **or** the revaluation model. Therefore it is **perfectly possible** that owner occupied properties are measured using fair value.

Under the revaluation model, properties are revalued with sufficient regularity to ensure that their year-end carrying amount does not differ significantly from their year-end fair value. This does not necessarily have to mean a new revaluation every year.

Where the revaluation of an owner occupied property results in a **surplus**, then the surplus is recognised in **other comprehensive income** unless it is reversing a revaluation deficit on the same asset which was **previously** recognised in profit or loss.

Where the revaluation results in a **deficit**, then the deficit is recognised in **profit or loss** unless it is reversing a revaluation surplus on the same asset which was **previously** recognised in other comprehensive income.

Exhibit 3 – Assets

The reason for the different treatment of the assets of Aston and Bern in the consolidated financial statements is due to the way the subsidiaries joined the group.

The assets of Aston arose as a result of the internal development of the company as part of the Omega group.

The goodwill attaching to Aston and its brand name are internally developed intangible assets. Recognition and measurement of such assets is dealt with in accordance with the requirements of IAS 38 – *Intangible Assets*.

IAS 38 prohibits the recognition of internally developed intangible assets unless they arise as part of a research and development project. Therefore it is inappropriate to recognise the goodwill attaching to Aston and its brand name in the consolidated financial statements of Omega.

The subsidiary Bern was acquired as a business combination. Accounting for business combinations is dealt with by IFRS 3 – *Business Combinations*.

IFRS 3 requires that, in the case of a business combination, the difference between the fair value of the consideration given and the fair values of the net assets acquired be recognised as goodwill arising on acquisition.

IFRS 3 requires that the assets and liabilities of a newly acquired subsidiary are separately identified and measured at fair value.

Therefore, provided the brand name attaching to Bern can be reliably fair valued, it would be recognised as an intangible asset in the consolidated financial statements of Omega.

The carrying amount of Bern's property, plant and equipment in the consolidated financial statements of Omega would be based on its fair value at the date of acquisition by Omega, whereas the carrying amount of Aston's property, plant and equipment in the consolidated financial statements of Omega would be based on its historical cost to Aston (and the group), presumably a lower figure.

	<i>Marks</i>
1 Consolidated statement of financial position	
Non-current assets	
– PPE and financial assets	1·5
– Goodwill	4
– Investment in associate	2·5
Current assets	2·5
Equity	
– Share capital and other components of equity	2
– Retained earnings	7
– Non-controlling interest	1·5
Non-current liabilities	
– Long-term borrowings	2·5
– Deferred tax	0·5
Current liabilities	1
	<u>25</u>
2 (a)	
– Explanations per IAS 19	5·5
– Calculations	4·5
– Explanations per IAS 2	3
– Calculations	1·5
– Explanations per IAS 10	1·5
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(b) Earnings per share calculation	5
(c) Ethics	4
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3 Exhibit 1	
– Explanations per IAS 12	9
Exhibit 2	
Transaction (a)	
– Explanations IAS 12	1
– Calculations	4
Transaction (b)	
– Explanations IFRS 9	1
– Explanations IAS 12	1
– Calculations	2
Transaction (c)	
– Explanation IAS 36	2
– Calculations IAS 36	1·5
– Explanation IAS 12	0·5
Presentation IAS 12	3
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4 Exhibit 1	
– Explanations per IFRS 13	8
Exhibit 2	
– Explanations per IFRS 13	2
– Explanations per IAS 16	5
– Explanations per IAS 40	3
Exhibit 3	
– Explanations per IAS 38	2·5
– Explanations IFRS 3	4·5
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