# Answers

## 1 Consolidated statement of profit or loss for Alpha for the year ended 31 December 20X9

| | $'000 |
|---|---|
| Revenue (W1) | 2,173,000 |
| Cost of sales (W2) | (602,600) |
| Gross profit | 1,570,400 |
| Operating expenses (679,000 + 59,000) | (738,000) |
| Operating profit | 832,400 |
| Investment income (128,000 – 80% x 51,000 + 75% x 67,000) | 36,950 |
| Finance costs (30,000 + 8,000) | (38,000) |
| Profit before tax | 831,350 |
| Income tax expense (280,000 + 19,000) | (299,000) |
| Profit for the year from continuing operations | 532,350 |
| Profit from discontinued operations (W5 – 1 mark for **principle**) | 165,469 |
| Profit for the year | 697,819 |
| Attributable to: | |
| Shareholders of Alpha (balancing figure) | 664,656 |
| Non-controlling interest (W10) | 33,163 |
| | 697,819 |

| | $'000 |
|---|---|
| **Shareholders of Alpha:** | |
| Profit for the period from continuing operations (532,350 – 12,400 (see below)) | 519,950 |
| Profit for the period from discontinuing operations (165,469 – 20,763 (see below)) | 144,706 |
| | 664,656 |
| **Non-controlling interests:** | |
| Profit for the period from continuing operations (62,000 x 20%) | 12,400 |
| Profit for the period from discontinuing operations ((84,000 – 950 (W5)) x 25%) | 20,763 |
| | 33,163 |

### Workings

#### Working 1 – Revenue

| | $'000 |
|---|---|
| Alpha + Beta ($1,935,000 + $280,000) | 2,215,000 |
| Intra-group revenue | (42,000) |
| | 2,173,000 |

#### Working 2 – Cost of sales

| | $'000 |
|---|---|
| Alpha + Beta ($495,000 + $132,000) | 627,000 |
| Intra-group purchases | (42,000) |
| Unrealised profit (1/4 x $19,200) | 4,800 |
| Impairment of Beta goodwill (W4) | 12,800 |
| | 602,600 |

#### Working 3 – Goodwill on acquisition of Beta

| | $'000 |
|---|---|
| Cost of investment (80m/2 = 40m x $3·20) | 128,000 |
| NCI (20% x $100m) | 20,000 |
| *Less* fair value of net assets at date of acquisition | (100,000) |
| Goodwill on acquisition | 48,000 |

**Working 4 – Impairment of goodwill in Beta**

| | $'000 |
|---|---|
| Net assets at 31 December 20X9 | 191,000 |
| *Add* goodwill (grossed up $48 million (W3) x 100/80) | 60,000 |
| Total | 251,000 |
| Recoverable amount | 235,000 |
| Impairment | 16,000 |
| Group share (80%) | 12,800 |

**Working 5 – Profit from discontinued operation**

| | $'000 |
|---|---|
| Profit of Gamma to 31 August 20X9 ($126,000 x 8/12) | 84,000 |
| Fair value adjustment to profit ($11·4m x 1/8 x 8/12) | (950) |
| Gain on disposal of Gamma (W6) | 120,419 |
| Tax on gain on disposal | (38,000) |
| Profit from discontinued operation | 165,469 |

**Working 6 – Gain or loss on disposal of Gamma**

| | $'000 |
|---|---|
| Disposal proceeds | 330,000 |
| *Less* net assets at date of disposal (W7) | (237,775) |
| *Less* goodwill at date of disposal (W8) | (20,500) |
| *Add* NCI at date of disposal (W9) | 48,694 |
| | 120,419 |

**Working 7 – Net assets of Gamma on date of disposal**

| | $'000 |
|---|---|
| At 1 January 20X9 | 211,000 |
| Profit to date of disposal ($126,000 x 8/12 – OF rule applies from W5) | 84,000 |
| Dividend paid 30 June 20X9 | (67,000) |
| Fair value adjustment to property: | |
| Depreciable component ($11·4m x 52/96) | 6,175 |
| Non-depreciable component ($15m – $11·4m) | 3,600 |
| | 237,775 |

**Working 8 – Goodwill of Gamma at date of disposal**

| | $'000 |
|---|---|
| Cost of investment | 95,000 |
| NCI in Gamma at date of acquisition (2·5m x $4·20) | 10,500 |
| *Less* fair value of net assets of Gamma at date of acquisition | (85,000) |
| | 20,500 |

**Working 9 – NCI in Gamma at date of disposal**

| | $'000 |
|---|---|
| NCI at date of acquisition (W8) | 10,500 |
| 25% of movement since acquisition ($237,775 (W7) – $85,000) | 38,194 |
| | 48,694 |

**Working 10 – Non-controlling interest**

| | $'000 |
|---|---|
| Beta – 20% x $62,000 | 12,400 |
| Gamma – 25% x ($84,000 – $950) (W5 – OF rule applies here) | 20,763 |
| | 33,163 |

**2** **Attachment to email**

The relevant standard is **IAS 16** – *Property, Plant and Equipment* (PPE). IAS 16 states that the cost of an item of PPE should be its purchase price plus any costs directly attributable to bringing the asset to the location and condition for it to be capable of operating in the manner intended by management (**principle**).

Under this principle, the **materials** used in the construction of the plant should be included in the cost of PPE and also the **production overheads** directly related to its construction.

However, IAS 16 does **not allow general administrative overheads** to be included as part of PPE. Such overheads ($1 million in this case) should be recognised in the statement of profit or loss as an **operating expense**.

IAS 16 **allows** the cost of employee benefits payable to construction staff to be included in the cost of PPE, but **only** those costs incurred during the construction period, which is January and February 20X5. Therefore **$1 million** (2 x $500,000) will be included in PPE whilst the other $2 million will be recognised in the statement of profit or loss as an **operating expense**.

The costs of training staff to operate the new plant **cannot be recognised in PPE since** they are specifically disallowed by IAS 16. These costs ($600,000) should be recognised in the statement of profit or loss as an **operating expense**.

The cost of $200,000 to test the operating systems to ensure they are fit for purpose are necessary to enable the plant to be used and should be recognised in PPE.

The costs of an opening ceremony **cannot** be recognised in PPE and should be recognised in the statement of profit or loss as an **operating expense**.

Under the principles of IFRS 9 – *Financial Instruments* – the borrowing is a **financial liability** measured using the **amortised cost** method.

The initial carrying amount of the financial liability should be the **net proceeds** received from the lender of $7·8 million. The borrowing fee should **not** be included in PPE (principle).

The difference of $720,000 ($8·52 million – $7·8 million) between the initial carrying amount of the borrowing and the final repayment will be a finance (borrowing) cost (**principle**). In this case, the finance cost for the year ended 30 June 20X5 will be **$420,000** ($720,000 x 7/12).

Under the principles of IAS 23 – *Borrowing Costs* – costs of borrowings taken out to finance the construction of an asset are recognised in PPE during the period in which activities are taking place in order to get the asset ready for use (**principle**). In this case, the borrowing (finance) costs which are recognised in this way will be those incurred in the three-month period from 1 January 20X5 to 1 April 20X5 of **$180,000** ($720,000 x 3/12).

The remaining borrowing costs of **$240,000** ($420,000 – 180,000) will be recognised in the **statement of profit or loss as a finance cost**.

The closing borrowings balance will be **$8,220,000** ($7·8 million + $420,000). This will be recognised in the statement of financial position as a **current liability**.

Under the principles of **IAS 37** – *Provisions, Contingent Liabilities and Contingent Assets* – a provision for the environmental rectification cost is required **if** there is an obligation arising out of a past event which can be reliably measured.

Although there is no legal obligation to rectify the damage, Theta has, by its reputation, created a constructive obligation and will undertake this expenditure, so a provision is required – sense of the point.

Where the time value of money is material, IAS 37 requires that the provision be measured at the present value of the expected future expenditure (**principle**). Therefore the provision which should be recognised from **1 March 20X5** (the date construction is completed and the environmental damage caused) and measured at **$1·5 million** ($10 million x 0·15).

Under the **principles** of IAS 16 this recognition provision is included as part of the cost of PPE, so an additional **$1·5** million is included in PPE.

Therefore the total amount included in the cost of PPE at 30 June 20X5 is $8,880,000 (W1).

Depreciation should be charged from 1 April 20X5, the date the asset is available for use (principle).

Therefore depreciation for the year ended 30 June 20X5 will be $111,000 ($8,880,000 x 1/20 x 3/12).This will be recognised in the **statement of profit or loss** as an operating expense.

The closing balance of PPE will be **$8,769,000** ($8,880,000 – $111,000). This will be recognised as a **non-current asset** in the statement of financial position.

As the date for payment of the $10 million rectification cost gets closer, the discount unwinds and the unwinding amount is added to the recognised provision (principle).

For the year ended 30 June 20X5, the amount of the unwinding is **$50,000** ($1·5 million x 10% x 4/12). $50,000 will be recognised in the statement of profit or loss as a **finance cost**.

The closing provision will be **$1,550,000** ($1·5 million + $50,000). This will be recognised as a **non-current** liability in the statement of financial position.

**W1 – Spreadsheet workings: total cost of PPE at 30 June 20X5**

| | $'000 |
|---|---|
| Material cost | 4,000 |
| Production overheads | 2,000 |
| Construction staff salaries | 1,000 |
| Costs of testing the operating systems | 200 |
| Attributable finance costs | 180 |
| Environmental rectification provision | 1,500 |
| | 8,880 |

**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 use this information for personal gain by purchasing shares in advance of an anticipated rise in the share price following the release of the results.

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 refer to an intimidation threat here will receive appropriate credit*).

You are in danger of breaching the fundamental principle of confidentiality when you ask your friend for advice. This request is almost bound to mean that you disclose confidential information to your friend.

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 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 – Construction contract**

The financial reporting treatment of this contract is governed by **IFRS 15** – *Revenue from Contracts with Customers*.

Delta has a single performance obligation, to construct and install a machines.

Delta must establish the timing of recognition of revenue as to **when the performance obligation is satisfied**. IFRS 15 allows for two scenarios, the performance obligation being satisfied **over time** or the performance obligation being satisfied **at a point in time**.

IFRS 15 states that a performance obligation is satisfied when control of the goods (or services) is transferred to the customer. In the current circumstances, given that Delta is constructing and installing the machines at the customer's premises, then 'control' of the machines is being transferred to the customer as they are being constructed. Therefore the performance obligation is being satisfied over time and the revenue is recognised on this basis – sense of the point.

Given that the performance obligation is being satisfied over time, it is necessary to measure the extent of its completion at the reporting date. The question tells us that Delta uses input methods to measure the extent of completion. This involves computing the costs incurred up to 30 June 20X5 as a proportion of the total expected costs of the project – sense of the point.

IFRS 15 states that costs which were **not originally envisaged** when the contract was planned, and are caused by inefficiencies or similar issues, should be charged to **profit or loss** as incurred rather than being included as a 'contract cost'. The **same applies** to any general or administrative overheads.

In this case, the cost of wasted materials and labour costs of disposal of wasted material of **$350,000** ($250,000 + $100,000) as well as the 'allocated general overheads' of **$480,000** should be charged to the statement of profit or loss for the year ended 30 June 20X5.

At 30 June 20X5, the performance obligation would be regarded as being 52·9% satisfied (W1).

The consideration for the contract includes a variable component (based on completion dates). Where this occurs, IFRS 15 states that the revenue should be based upon the estimated amount receivable from the customer in exchange for the promised goods – sense of the point.

The total revenue will be estimated as $12·2 million (W2).

Therefore the revenue which will be recognised in the statement of profit or loss will be $6,453,800 ($12·2 million x 52·9%).

Costs associated with the contract which will be recognised in the statement of profit or loss will be $4·5 million (W1).

The statement of financial position at 30 June 20X5 will show, as a **current asset**, a contract asset of **$453,800** (W3).

W1 – % age of completion calculation

| | Total estimated cost | Cost to date |
|---|---|---|
| | $'000 | $'000 |
| Commission | 300 | 300 |
| Materials | 4,200 | 2,200 |
| Direct labour | 2,000 | 1,000* |
| Depreciation | 1,200 | 600 |
| Sub-contractors | 800 | 400 |
| Total cost for completion calculation | 8,500 | 4,500 |

* This represents the $1·1 million labour costs incurred to date less the labour costs ($100,000) relating to the inefficient working which are taken straight to profit or loss.

**Thus the contract is regarded as 52·9% complete ((4,500/8,500) x 100%).**

W2 – Estimate of total revenue on the contract

| | $'000 |
|---|---|
| Original contracted price | 12,000 |
| Reduction for expected four-week overrun (4 x $100,000) | (400) |
| Expected additional amount due to premium quality of the work | 600 |
| Total expected revenue | 12,200 |

W3 – Contract asset at 30 June 20X5

| | $'000 |
|---|---|
| Revenue recognised by Delta (52·9% x $12·2m) | 6,453·8 |
| *Less:* invoiced by 30 June 20X5 | (6,000) |
| Contract asset | 453·8 |

Exhibit 2 – Joint arrangement

The financial reporting treatment of this arrangement is governed by **IFRS 11 –** ***Joint Arrangements***. IFRS 11 states that a joint arrangement is one of which two or more parties have joint control.

The arrangement between Delta and Drax is a joint arrangement because all the decisions relating to the product must be agreed by both parties, so they have joint control (sense of the point).

An arrangement is a joint operation **when the parties to the arrangement have rights to the assets and obligations for the liabilities** of the arrangement. This is the type of arrangement which Delta and Drax have entered into.

When accounting for a joint operation, each operator includes its share of the assets, liabilities, revenues and expenses of the operation (sense of the point).

This means that Delta will recognise the following amounts in the **statement of profit or loss** for the year ended 30 June 20X5:

Revenue of **$20 million** ($40 million x **50%**).

Cost of sales of **$13 million** ($26 million x 50%).

Advertising and distribution costs of **$700,000** (50% x ($400,000 + $1 million).

Delta will recognise the following amounts under **current assets** in the **statement of financial position** at 30 June 20X5:

**Trade receivables** of **$4 million** (50% x ($40 million – $32 million).

**Inventories $1·75 million** (W1).

An amount receivable from Drax of **$15·95** million (W2).

W1 – Inventories of Delta at 30 June 20X5

| | Total | Delta share (50%) |
|---|---|---|
| | $'000 | $'000 |
| Raw materials purchased by Delta | 6,500 | 3,250 |
| Manufacturing costs incurred by Delta | 8,500 | 4,250 |
| Manufacturing costs incurred by Drax | 14,500 | 7,250 |
| Transferred to cost of sales | (26,000) | (13,000) |
| So closing inventories equals | 3,500 | 1,750 |

W2 – Balance receivable from Drax on 30 June 20X5

| | Debit $'000 | Credit $'000 |
|---|---|---|
| Raw materials purchased by Delta (Drax share) | 3,250 | |
| Manufacturing costs incurred by Delta (Drax share) | 4,250 | |
| Manufacturing costs incurred by Drax (Delta share) | | 7,250 |
| Advertising and distribution costs incurred by Delta (Drax share) | 200 | |
| Advertising and distribution costs incurred by Drax (Delta share) | | 500 |
| Cash collected from customers by Drax (Delta share) | 16,000 | |
| Balance carried forward (debit) | | 15,950 |
| | 23,700 | 23,700 |

**4** Exhibit 1 – Disclosures

The transactions with Gower need to be disclosed because Gower is a **related party** of Omega (the reporting entity) according to IAS 24 – ***Related Party Disclosures***.

IAS 24 states that a director of an entity is a member of the key management personnel (KMP) of that entity. Key management personnel are automatically related parties. Therefore the MD of Gower is a related party of Omega as he is a director of Omega.

IAS 24 further states that close family members of the related parties of an entity are themselves related parties. Therefore the spouse of the director would also be a related party of Omega.

Finally, IAS 24 states that because Gower is **controlled** by the spouse of a director of Omega, then Gower is itself a related party of Omega.

Disclosures required relating to Gower in the consolidated financial statements would be the nature of the related party relationship, the amount of transactions in the period, and the amount of any outstanding balances with Gower (likely to be payables) at the year end.

The nature of related party relationships is such that materiality is considered using qualitative measures as well as quantitative ones. Therefore despite their relatively small amounts, transactions with Gower might need to be disclosed in the consolidated financial statements of Omega to enable the users to assess their significance (sense of the point).

Dixon is not a related party of Omega, so disclosure of transactions and balances would only be necessary if this was considered relevant to the overall understanding of the consolidated financial statements (sense of the point).

Exhibit 2 – Investment in Newco

Newco is not a subsidiary of Omega. Based on the principles outlined in **IFRS 10** – *Consolidated Financial Statements* – a subsidiary entity is one which is **controlled** by the investor. The facts here indicate that Omega cannot exercise control over Newco, **based on** a shareholding of only 35% and an ability to appoint only two out of its six directors.

The ability to appoint two of the six directors, and the ownership of 35% of the shares would, however, given the rights of appointment of the other directors, and the ownership of the other shares, appear to give Omega the ability to exercise significant influence over Newco – sense of the point.

Under the principles of **IAS 28** – *Investments in Associates and Joint Ventures* – Newco would be regarded as an **associate** of Omega because of the ability of Omega to exercise significant influence. IAS 28 contains a rebuttable presumption that ownership of **20%** or more of the equity shares of an entity gives the investor the ability to exercise significant influence.

**Where the investor prepares consolidated financial statements** (the case for Omega), then IAS 28 requires the investor to account for the investment in the associate under the **equity method**. Under the equity method, the investment in the associate is shown at **cost plus the investor's share of the post-acquisition change in net assets of the associate**. The post-acquisition increase in the carrying amount of the investment is shown in **profit or loss or other comprehensive income**.

If there are transactions between the associate and the investor, then any profits made by either party are eliminated to the extent of the investor's share in the associate. If, at the year end, the investment in the associate has suffered impairment, then the investment should be written down to its recoverable amount.

The increase in the carrying amount of Omega's investment in Newco **implies** that, since acquisition, the net assets of Newco have increased by $10 million and Newco's share of this increase is $3·5 million.

This means that the carrying amount of $63·5 million for the investment in Newco is not necessarily the value of the shares at the year end. This value will be determined by market forces – sense of the point.

Exhibit 3 – Financial statements of Tiny and Minor

Based on the principles outlined in **IFRS 10** – *Consolidated Financial Statements* – all group entities should be reflected in the consolidated financial statements by applying uniform accounting policies. If individual group entities prepare their financial statements using accounting policies which differ from those of the parent, then appropriate adjustments should be made when reflecting their assets, liabilities, profits and losses in the consolidated financial statements.

It would suggest that due to the size of the company, Minor is preparing its financial statements using the IFRS for SMEs (SMEs Standard) while Tiny is applying the full International Financial Reporting Standards (IFRS standards) – sense of the point.

The ability to use the SMEs Standard, however, does not depend on the size of the reporting entity, but on whether or not the entity is 'publicly accountable'. It is likely therefore that Minor is not 'publicly accountable'.

Entities which are not publicly accountable have the right, but not the obligation, to use the SMEs Standard rather than full IFRS standards. This could explain why Minor is using the SMEs Standard but Tiny is not.

The SMEs Standard contains less detailed reporting requirements than full IFRS standards and provides for more straightforward accounting treatments in certain cases – sense of the point.

A specific example of the above is that under the SMEs Standard, all research and development costs are charged as an expense in the statement of profit or loss in all circumstances.

Accounting for research and development costs under full IFRS is governed by **IAS 38** – *Intangible Assets*. IAS 38 requires that development costs are recognised as an intangible asset once there is a separately defined project, with clearly identifiable expenditure, adequate resources to complete the project, and reasonable certainty that future economic benefits will exceed the capitalised costs. IAS 38 requires research costs to be charged as an expense to profit or loss in all circumstances because at the research stage there is no definite prospect of future benefit for the reporting entity – sense of the point.

In future periods it might be beneficial to require Minor to use full IFRS standards in the preparation of its individual financial statements to make the consolidation process more straightforward as no adjustments would be required.

| | | Marks |
|---|---|---|
| **1** | **Statement of profit or loss** | |
| | – Revenue | 1 |
| | – Cost of sales | 2 |
| | – Impairment of Beta goodwill | 5·5 |
| | – Investment income | 1·5 |
| | – Operating expenses, finance costs, income tax | 1·5 |
| | | 11·5 |
| | **Profit from discontinued operations** | |
| | – Gain on disposal of Gamma | 7 |
| | – Profit share, fair value adjustment, tax | 3·5 |
| | | 10·5 |
| | **Profit for the year** | |
| | – Shareholders of Alpha | 0·5 |
| | – Non-controlling interest | 2·5 |
| | | 3 |
| | | **25** |
| **2** | Attachment 1 | |
| | – Explanations per IAS 16 | 5·5 |
| | – Calculations | 1 |
| | – Explanations per IFRS 9 | 3 |
| | – Calculations | 2·5 |
| | – Explanations per IAS 23 | 1 |
| | – Calculations | 0·5 |
| | – Explanations per IAS 37 | 5 |
| | – Calculations | 2·5 |
| | | 21 |
| | Ethics | 4 |
| | | **25** |
| **3** | Exhibit 1 | |
| | – Explanations per IFRS 15 | 8 |
| | – Calculations | 7 |
| | | 15 |
| | Exhibit 2 | |
| | – Explanations per IFRS 11 | 5 |
| | – Calculations | 5 |
| | | 10 |
| | | **25** |

| | | Marks |
|---|---|---|
| **4** | **Exhibit 1** | |
| | – Explanations per IAS 24 | **7** |
| | | |
| | **Exhibit 2** | |
| | – Explanations per IFRS 10 | 1 |
| | – Explanations per IAS 28 | 7 |
| | | **8** |
| | | |
| | **Exhibit 3** | |
| | – Explanations per IFRS 10 | 2 |
| | – Explanations IFRS for SMEs | 5 |
| | – Explanations per IAS 38 | 3 |
| | | **10** |
| | | **25** |