
Answers

1 Consolidated statement of financial position of Alpha at 31 March 20X5

[Note: all figures below in \$'000]

	\$'000
Assets	
Non-current assets	
Property, plant and equipment (380,000 + 185,000 + 18,000 (W1) – 2,463 (W5))	580,537
Goodwill (W2)	46,800
	<u>627,337</u>
Current assets	
Inventories (90,000 + 65,000 – 4,000 (W4))	151,000
Trade receivables (100,000 + 50,000)	150,000
Cash and cash equivalents (35,000 + 20,000)	55,000
	<u>356,000</u>
Total assets	<u><u>983,337</u></u>
Equity and liabilities	
Equity attributable to equity holders of the parent	
Share capital (\$1 shares)	200,000
Retained earnings (W4)	140,216
Other components of equity (W8)	76,560
	<u>416,776</u>
Non-controlling interest (W3)	42,880
Total equity	<u>459,656</u>
Non-current liabilities	
Long-term borrowings (200,000 + 20,000 – 5,419 (W6))	214,581
Deferred tax (20,000 + 10,000 + 3,600 (W1))	33,600
Total non-current liabilities	<u>248,181</u>
Current liabilities	
Trade and other payables (85,000 + 60,000)	145,000
Current tax payable (40,000 + 30,000)	70,000
Deferred consideration payable to former shareholders of Beta (W7)	60,500
Total current liabilities	<u>275,500</u>
Total liabilities	<u>523,681</u>
Total equity and liabilities	<u><u>983,337</u></u>

Working 1 – Net assets table for Beta

	1 April 20X3 \$'000	31 March 20X5 \$'000
Share capital	100,000	100,000
Retained earnings:		
Per financial statements of Beta	60,000	80,000
Fair value adjustment to PPE (post-acquisition additional depreciation = 30,000 x 2/5 = 12,000)	30,000	18,000
Deferred tax on fair value adjustment	(6,000)	(3,600)
Other components of equity	20,000	20,000
Net assets for the consolidation	<u>204,000</u>	<u>214,400</u>

Post-acquisition increase in net assets (214,400 – 204,000) = 10,400

Working 2 – Goodwill on acquisition of Beta

	\$'000
Cash cost of shares purchased	160,000
Deferred consideration (66,500 x 0.75132)	50,000
Non-controlling interest at date of acquisition (204,000 (W1) x 20%)	40,800
Net assets at date of acquisition (W1)	<u>(204,000)</u>
Goodwill on acquisition equals	<u>46,800</u>

Working 3 – Non-controlling interest in Beta

	\$'000
At date of acquisition (W2)	40,800
20% of post-acquisition increase in net assets (20% x 10,400 (W1))	2,080
	<u>42,880</u>

Working 4 – Retained earnings

	\$'000
Alpha – per draft SOFP	160,000
Adjustment to carrying amount of PPE (W5)	(2,463)
Adjustment to finance cost of convertible loan (5,141 (W6) – 4,000)	(1,141)
Acquisition costs	(10,000)
Finance costs of deferred consideration on acquisition of Beta (5,000 + 5,500 (W7))	(10,500)
80% of post-acquisition share of Beta' profits (80% x 10,400 (W1))	8,320
Unrealised profit on sales to Beta (20/120 x 24,000)	(4,000)
	<u>140,216</u>

Working 5 – Adjustment to carrying amount of PPE

	\$'000
Construction cost	60,000
Finance cost eligible for capitalisation (60,000 x 8% x 4/12)	1,600
	<u>61,600</u>
Depreciation (61,600 x 1/10 x 4/12)	(2,053)
Correct carrying amount	59,547
Carrying amount per draft financial statements of Alpha	(62,010)
Adjustment to carrying amount equals	<u>(2,463)</u>

Working 6 – Adjustment to carrying amount of convertible loan

	\$'000
Carrying amount on 1 April 20X4 (4,000 x 4·10 + 80,000 x 0·713)	73,440
Finance cost for year ended 31 March 20X5 (73,440 x 7%)	5,141
Cash interest paid on 31 March 20X5	(4,000)
	<u>74,581</u>
Carrying amount on 31 March 20X5	(80,000)
Adjustment to carrying amount equals	<u>(5,419)</u>

Working 7 – Deferred consideration payable to former shareholders of Beta

	\$'000
At 1 April 20X3 (W2)	50,000
Finance cost for year ended 31 March 20X4 (50,000 x 10%)	5,000
	<u>55,000</u>
Finance cost for year ended 31 March 20X5 (55,000 x 10%)	5,500
At 31 March 20X5	<u>60,500</u>

Working 8 – Other components of equity

	\$'000
Alpha – per draft SOFP	70,000
Equity component of convertible loan (80,000 – 73,440 (W6))	6,560
	<u>76,560</u>

2 Attachment 1 to email

The relevant standard is IFRS 2 – *Share-based Payment*. Under IFRS 2, the offer of shares to senior executives is a share-based payment transaction which must be recognised in the financial statements (*principle*).

This particular transaction (a share-based payment transaction with a cash alternative) is treated partly as an equity settled share-based payment transaction and partly a cash settled one (*principle*).

The fair value of the equity settled element at the grant date is computed by deducting the fair value of the cash alternative at the grant date from the overall fair value of the offer of the shares with the cash alternative (*exact words not necessary – principle*). This is because the executives (counterparty) and not the entity have the choice as to whether to take the shares or cash.

The fair value of the equity settled part of the transaction is \$72,000 [$12,000 \times \9 (the fair value of the overall share offer) $\times 9$ executives – $10,000 \times \$10$ (the fair value of the cash alternative) $\times 9$].

The equity settled part of the arrangement is recognised as a remuneration expense over the three-year vesting period based on its fair value at the grant date and the number of shares which are actually expected to vest (*principle*).

Therefore the amount which is recognised in the year ended 31 March 20X5 is \$24,000 ($\$72,000 \times 1/3$).

The corresponding credit entry in the statement of financial position is to other components of equity and will not be re-measured.

The remuneration expense associated with the liability component of the arrangement is also recognised over the vesting period and based on the number of shares which are actually expected to be issued on vesting. However, the expense is measured based on the fair value of the liability component at the reporting date (*principle*).

Therefore the total amount which is recognised in profit or loss as a remuneration expense in the year ended 31 March 20X5 is $\$384,000 = ((9 \times 10,000 \times \$12 \times 1/3) = \$360,000 + \$24,000$ [above]).

The corresponding credit entry of \$360,000 in the statement of financial position is to non-current liabilities.

Tutorial note: Candidates may present as a journal:

DR Profit or loss – Remuneration expense	\$384,000	
CR Non-current liability		\$360,000
CR Other components of equity		\$24,000

Attachment 2 to email

The relevant standard is IAS 16 – *Property, Plant and Equipment* (PPE). Where PPE is revalued and the revaluation shows a surplus, then, unless the surplus is eliminating a previous revaluation deficit on the same asset, the surplus is recognised in other comprehensive income rather than profit or loss (*principle*).

Since this is a first time revaluation, then a surplus of \$10 million (\$30 million – \$20 million) will be recognised in other comprehensive income.

Regardless of future potential increases in value, assets which are revalued still need to be depreciated over their estimated future useful lives (*principle*).

Land generally has an indefinite life, so only the buildings element of the property needs to be depreciated (*principle*).

This means that the depreciation charge on the property for the year ended 31 March 20X5 will be \$0.9 million ($\$18 \text{ million} \times 1/20$). \$0.9 million will be charged as an expense in the statement of profit or loss.

The carrying amount of the property at 31 March 20X5 will be \$29.1 million ($\$30 \text{ million} - \0.9 million). This will be presented as part of non-current assets in the statement of financial position.

Under the principles of IAS 12 – *Income Taxes* – a deferred tax liability must be recognised on the revaluation of an asset even if there is no intention to dispose of the asset (*principle*).

IAS 12 requires that a deferred tax liability be recognised on the difference between the carrying amount of an asset and its tax base (*principle*).

So for this property, the deferred tax liability prior to its revaluation will be \$5 million ($25\% \times \$20 \text{ million} - \0 tax base).

After the revaluation, the deferred tax liability will increase to \$7.5 million ($25\% \times \$30 \text{ million} - \0 tax base).

The increase of \$2.5 million following the revaluation will be debited to other comprehensive income.

The net credit to other comprehensive income as a result of the revaluation will be \$7.5 million ($\$10 \text{ million} - \2.5 million). This net credit will be recognised as a revaluation surplus in the statement of financial position as part of 'other components of equity'.

The deferred tax liability on 31 March 20X5 will be \$7.275 million ($\$29.1 \text{ million} \times 25\%$). This will be presented as a non-current liability in the statement of financial position.

The reduction in the deferred tax liability between 1 April 20X4 and 31 March 20X5 will be \$0.225 million ($\$7.5 \text{ million} - \7.275 million). This will be shown as a credit to the income tax expense in the statement of profit or loss.

Tutorial note: Some candidates may mention the option given in IAS 16 for entities which measure PPE using the revaluation model to make a transfer between the revaluation surplus and retained earnings. This transfer is based on the difference between depreciation actually charged on the revalued asset – in this case \$0.9 million – and the depreciation which would have been

charged had the asset continued to be measured at historical cost. This amount would have been \$0.5 million (\$10 million x 1/20), so the gross transfer for the year ended 31 March 20X5 would have been \$0.4 million (\$0.9 million – \$0.5 million). Where deferred tax is taken into consideration, the transfer is made net of attributable taxation. The accounting entry in this case would be:

	\$m	\$m
Credit retained earnings (\$0.4 million x (100 – 25)%)		0.30
Debit revaluation reserve	0.30	

Candidates who take this approach will be awarded a maximum of 3 additional marks (but the total for attachment 2 cannot exceed 10 marks).

Email from finance director (FD)

You are in danger of breaching the fundamental ethical principle of objectivity. You have a personal interest in reporting a favourable profit because of the possibility of a profit related bonus.

You also may be breaching the fundamental ethical principle of professional competence. As only part qualified and only part-way through a training programme, you may well not be competent enough to make a decision on the complex transactions outlined by the FD.

You are also breaching the fundamental ethical principle of integrity. It is at least possible that the FD is deliberately seeking to falsify the financial statements. If you are complicit and comply with the instructions of the FD, then there is a danger that this principle will be breached.

It is not appropriate to reveal the detail in the attachments to that email to a friend who is not employed by Gamma. This clearly breaches the fundamental ethical principle of confidentiality.

3 Exhibit 1 – Post-employment benefit plans

The relevant standard to apply here is IAS 19 – *Employee Benefits*. Since the benefits payable to plan A members are dependent on the value of the investment fund, plan A is a defined contribution plan.

This means that the liability of Delta is limited to the payment of contributions into the plan. Delta has no responsibility for the adequacy of the plan or payments to the former employees.

Therefore the contributions payable by Delta for the period of **\$45 million** will be shown as an **employment expense in the statement of profit or loss**. The current service cost is irrelevant to the financial reporting of amounts relating to a defined contribution plan.

The benefits paid to the former employees are paid by the plan and so are not relevant to Delta. Neither is the fair value of the plan assets.

Since the benefits payable to plan B members are based on final salary and length of service of the relevant employee, plan B is a defined benefit plan.

This means that the difference between the present value of the obligation (the liability of the plan to pay future benefits) and the fair value of the plan assets is reflected in the statement of financial position of Delta as a net liability or a net asset (*principle*).

Therefore the statement of financial position of Delta will record a net liability of **\$55 million** (\$220 million – \$165 million) at 31 March 20X5. This will be shown as a **non-current liability**.

Since there is no guarantee that the contributions payable to the plan will be sufficient to fund the benefits, it is the current service cost which is shown as an operating expense in the statement of profit or loss (*principle*). In this case, the relevant expense is **\$14 million**.

Since, for plan B, Delta has a constructive obligation to fund any deficits, it is appropriate to recognise a net interest cost in the statement of profit or loss. This is the net of the interest cost on the liability and the interest income on the assets (*principle – just sense of the point rather than the exact words*).

In this case, the net interest cost would be \$3.4 million (\$14.84 million (W1) – 11.44 million (W1)).

The benefits paid to the former employees are paid by the plan and so are not relevant to Delta.

The liability of the plan to pay future benefits is an estimate which is usually computed with reference to actuarial advice. This means that there will almost always be a difference between the net closing liability/asset after accounting for the other movements recognised in the financial statements and the actuarial valuations at the year end of the plan assets and liability (*principle – just sense of the point rather than the exact words*).

This difference is referred to in IAS 19 as an **actuarial gain or loss** and is recognised in **other comprehensive income**.

In this case, the actuarial loss is \$2.6 million (W2).

Working 1 – Net interest cost – plan B

	Asset \$'000	Liability \$'000
Opening balance	140,000	(190,000)
6/12 of the contributions of \$15,000 to plan in the period (increasing the asset)	7,500	
6/12 of the benefits of \$9,000 paid to employees in the period (reducing both the asset and the liability)	(4,500)	4,500
Average carrying amount of asset and liability in the period	143,000	(185,500)
Interest at 8%	11,440	(14,840)

Working 2 – Actuarial gain or loss – plan B

NB numbers below in \$'000

	\$'000
Opening net liability (190,000 – 140,000)	(50,000)
Current service cost	(14,000)
Net interest cost (W1 (14,840) less 11,440) – NB: OF rule applies here	(3,400)
Contributions payable by Delta into plan	15,000
Actuarial (loss)/gain – balancing figure	(2,600)
Closing net liability (220,000 – 165,000)	(55,000)

Exhibit 2 – Sale of goods with right of return

The relevant standard to apply here is IFRS 15 – *Revenue from Contracts with Customers*.

In order to determine the amount and timing of the revenue to be recognised, Delta needs to identify the contract with the customer and to identify the performance obligations for Delta contained in the contract. In this case, the contract, and the performance obligation, is to supply the items to the customer (*sense of the point*).

Delta then needs to determine the transaction price. Where the contract gives the customer a right of return, then the transaction price contains a variable element (*principle*).

Since the variable element can be reliably measured, then it is taken into account in measuring the transaction price (*principle*). This means that the transaction price is \$950,000 (200 x \$5,000 x 95%).

The transaction price needs to be allocated to the separate performance obligations in the contract. Where there is only one performance obligation, this is a straightforward matter (*sense of the point*).

Delta then needs to recognise the revenue as the performance obligation is satisfied. Since the performance obligation is to supply the items to the customer, then the revenue is recognised in full on 1 March 20X5 when the items are delivered (*sense of the point*). The revenue recognised on this date is \$950,000.

On 1 March 20X5, \$1 million (200 x \$5,000) will be recognised as a trade receivable.

\$50,000 (\$1 million – \$950,000) will be recognised as a refund liability. This will be a current liability.

The **total** cost of the goods sold is \$600,000 (200 x \$3,000). This amount will be removed from inventory on 1 March 20X5.

Only \$570,000 (200 x \$3,000 x 95%) of the above amount will be recognised in cost of sales. The other \$30,000 (\$600,000 – \$570,000) will be shown as a right of return asset under current assets.

The return of the six items during March 20X5 does not affect the initial recognition of revenue or cost of sales since the original estimate of the total returns is still considered valid (*principle*).

The sales value of the goods returned of \$30,000 (6 x \$5,000) will be credited to trade receivables and debited to the refund liability (*principle*).

This means that the closing balance of trade receivables will be \$970,000 (\$1 million – \$30,000) and the closing refund liability will be \$20,000 (\$50,000 – \$30,000).

The inventory value of the goods returned of \$18,000 (6 x \$3,000) will be debited to inventory and credited to the right of return asset (*principle*).

The closing balance of the right of return asset will be \$12,000 (\$30,000 – \$18,000).

4 Exhibit 1

Query 1

IFRS 10 – *Consolidated Financial Statements* – deals with the procedures to be followed when preparing such statements (*principle*).

IFRS 10 states that the financial information relating to any subsidiary entity should normally be prepared to the same reporting date as the reporting date of the parent entity (*principle*).

Where a subsidiary has a reporting date which differs from that of the parent, then it is normally necessary to prepare additional financial information relating to that subsidiary as of the same date as the reporting date of the parent (*principle*).

If this is not practicable, then IFRS 10 allows the parent to prepare consolidated financial statements which incorporate financial information for the subsidiary drawn up to the most recent reporting date of the subsidiary (*principle*).

In such circumstances, IFRS 10 requires adjustments to be made for 'significant' transactions which occur between the reporting date of the subsidiary and the reporting date of the parent (*principle*).

The above facility is only possible where the reporting dates of the subsidiary and the parent differ by three months or less (*principle*).

Therefore it would be possible to use the financial statements of NewSub for the year ended 31 December 20X4 to prepare the consolidated financial statements of Omega for the year ended 31 March 20X5 (*conclusion*).

There is no requirement for NewSub to change its year end following its acquisition by Omega but this might make the consolidation process more straightforward in the future (*sense of the point*).

Query 2

Segmental disclosures are required by IFRS 8 – *Operating Segments*.

IFRS 8 only applies to listed entities, so it is not necessary for NewSub to give such disclosures in its own individual financial statements.

Given that NewSub is now part of the Omega group, then disclosures relating to its operating segments would be required in theory in the consolidated financial statements of Omega.

In practice, the operating segments of NewSub would need to meet the criteria for them to be reportable in the consolidated financial statements of Omega (*sense of the point*).

These criteria are that the operating segments would be regularly reviewed by the Omega group management (chief operating decision maker) and they are material in the context of the Omega group.

In this context, 'material' means that the reported revenues, profits or assets of the segment are 10% or more of the combined reported revenues, profits or assets of all of the operating segments of the Omega group, i.e. exceeds the quantitative thresholds in IFRS 8.

Notwithstanding the quantitative thresholds, however, IFRS 8 permits entities to disclose information about operating segments if, in the judgement of management, such information would be useful to users.

Query 3

Accounting for investment properties is set out in IAS 40 – *Investment Property*.

IAS 40 states that investment properties are initially accounted for at cost (*principle*).

IAS 40 allows an accounting policy choice for subsequent measurement of investment properties.

IAS 40 allows either the cost model or the fair value model but requires a consistent choice of measurement model for all investment property.

On the date when Omega acquires NewSub, the 'cost' of NewSub's investment properties from the perspective of the consolidated financial statements would be their fair value at the date of acquisition of NewSub.

This means that, for the purposes of the Omega group consolidation, NewSub's investment properties will need to be measured using the fair value model. This will require on-going adjustments to be made at group consolidation level.

It is not necessary for NewSub to adjust its accounting policy in its own financial statements but for practical purposes this might be the preferred option going forward (*sense of the point*).

Exhibit 2 – Statement of profit or loss and other comprehensive income

Query 1

The overall requirements for presentation of financial statements are set out in IAS 1 – *Presentation of Financial Statements* (*principle*).

IAS 1 requires that the statement of profit or loss and other comprehensive income discloses certain key elements, for example, revenue and income tax expense (*principle*).

As far as other detailed line items are concerned, IAS 1 states that they should be presented in a manner that is relevant to an understanding of the financial performance of the reporting entity (*principle*).

In particular, IAS 1 states that operating expenses should be presented based on either their nature or their function, whichever provides financial information which is more reliable or relevant (*principle*).

Therefore it is perfectly possible that the detailed line items in the respective statements of Omega and Rival could be quite different while still complying with full IFRS standards (*conclusion*).

Query 2

As far as the allocation of items between profit or loss and other comprehensive income is concerned, IAS 1 states that all items of income and expense should be presented in profit or loss unless another IFRS standard requires or permits otherwise (*principle*).

There is no theoretical distinction between 'profit or loss items' and 'other comprehensive income items'. However, it is more likely for gains, rather than losses, to be recognised in other comprehensive income (for example, revaluation gains on re-measurement of property, plant and equipment are usually recognised in other comprehensive income whereas revaluation losses are unusually recognised in profit or loss).

Gains or losses which are recognised in profit or loss contribute to the computation of earnings per share (EPS). Those recognised in other comprehensive income do not.

EPS is a key performance indicator for listed entities which must be disclosed in the published financial statements.

This would therefore matter for both Omega and Rival (*conclusion*).

	<i>Marks</i>
1 Non-current assets	
– PPE	4
– Goodwill	4
	<u>8</u>
Current assets	<u>2</u>
Equity	
– Retained earnings	5.5
– NCI	1
– Other	1.5
	<u>8</u>
Non-current liabilities	
– Long-term borrowings	3
– Deferred tax	1
	<u>4</u>
Current liabilities	
– Deferred consideration	2
– Others	1
	<u>3</u>
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