Question 01

(a)

Consolidated statement of financial position	$
Investment in associate (W1)	2,058,000

Consolidated statement of profit or loss	
Share of profit of associate (W2)	28,000

Note: No adjustment is required for receivables and payables held between Paint and Animate.

(W1) **Investment in associate**

	$
Cost	2,000,000
Share of post-acquisition profit (30% × $800,000 × 6/12)	120,000
Share of excess depreciation (30% × (($1.8m – $1m)/10 years) × 6/12)	(12,000)
Impairment	(50,000)
Investment in associate	2,058,000

The inventory is held within the group so the parent's share of the PURP is credited against inventory rather than the investment in the associate.

(W2) **Share of associate's profit**

	$
P's share of A's profit after tax (30% × $800,000 × 6/12)	120,000
Impairment	(50,000)
P's share of excess depreciation (30% × (($1.8m – $1m)/10 years) × 6/12)	(12,000)
P's share of PURP (30% × $100,000)	(30,000)
Share of profit of associate	28,000

(b)

Question 02

(a) The hedged item is an investment in equity that is measured at fair value through other comprehensive income (OCI). Therefore, the increase in the fair value of the derivative of $90,000 and the fall in fair value of the equity interest of $100,000 since the inception of the hedge are taken to OCI.

The net result is a small loss of $10,000 in OCI.

Dr Derivative $90,000

Cr OCI $90,000

Dr OCI $100,000

Cr Equity investment $100,000

(b)

i. The futures contract is a derivative and is measured at fair value with all movements being accounted for through profit or loss.

The fair value of the futures contract at 1 October 20X1 was nil. By the year end, it had risen to $95,000. Therefore, at 31 December 20X1, Chive will recognise an asset at $95,000 and a gain of $95,000 will be recorded in profit or loss.

ii. If the relationship had been designated as a fair value hedge then the movement in the fair value of the hedging instrument (the future) and the fair value of the hedged item (the firm commitment) since inception of the hedge are accounted for through profit or loss.

The derivative has increased in fair value from $nil at 1 October 20X1 to $95,000 at 31 December 20X1. Purchasing CU2 million at 31 December 20X1 would cost Chive $100,000 more than it would have done at 1 October 20X1. Therefore the fair value of the firm commitment has fallen by $100,000.

At year end, the derivative will be held at its fair value of $95,000, and the gain of $95,000 will be recorded in profit or loss.

The $100,000 fall in the fair value of the commitment will also be accounted for, with an expense recognised in profit or loss.

(c)

The expense recognised for an equity-settled share-based payment scheme is calculated based on the fair value of the options at the grant date. This expense is spread over the vesting period. At each reporting date, the entity should reassess the number of options expected to vest.

The expense for the scheme in the year ended 30 June 20X9 is $250,000 (4 × 25,000 × $10 × 1/4).

For tax purposes, tax relief is allowed based on the intrinsic value of the options at the date they are exercised.

At the reporting date, the shares have a market value of $17 but the options allow the holders to purchase these shares for $5. The options therefore have an intrinsic value of $12 ($17 – $5).

The deferred tax asset is calculated as follows:

	$	$
Carrying value of share-based payment	Nil	
Tax base of the share-based payment (4 × 25,000 × ($17 – $5) × 1/4)	(300,000)	
	________	
× Tax rate 30%	(300,000)	
		________
Deferred tax asset		90,000
		________

Where the amount of the estimated future tax deduction exceeds the accumulated remuneration expense, this indicates that the tax deduction relates partly to the remuneration expense and partly to equity.

In this case, the estimated future tax deduction is $300,000 whereas the accumulated remuneration expense is $250,000. Therefore, $50,000 of the temporary difference is deemed to relate to an equity item, and the deferred tax relating to this should be credited to equity.

The following entry is required:

Dr Deferred tax asset	$90,000
Cr Equity ($50,000 × 30%)	$15,000
Cr Profit or loss ($250,000 × 30%)	$75,000

If the deferred tax asset is to be recognised, it must be capable of reliable measurement and also be regarded as recoverable.

Question 03
Part A

(a) **Explanatory note to: The directors of Moyes**
Subject: Cash flows generated from operations

(i)

	$
Profit before tax	209
Share of profit of associate	(67)
Service cost component	24
Contributions into the pension scheme	(15)
Impairment of goodwill	10
Depreciation	99
Impairment of property, plant and equipment ($43m – $20m)	23
Movement on inventory ($165m – $126m – $6m)	33
Loss on inventory	6
Increase in receivables	(7)
Increase in current liabilities	18
Cash generated from operations	333

(ii) Cash flows from operating activities are principally derived from the key trading activities of the entity. This would include cash receipts from the sale of goods, cash payments to suppliers and cash payments on behalf of employees. The indirect method adjusts profit or loss for the effects of transactions of a non-cash nature, any deferrals or accruals from past or future operating cash receipts or payments and any items of income or expense associated with investing or financing cash flows.

The share of profit of associate is an item of income associated with investing activities and so has been deducted. Likewise cash paid to acquire property, plant and equipment is an investing cash flow rather than an operating one. Non-cash flows which have reduced profit and must subsequently be added back include the service cost component, depreciation, exchange losses and impairments. With the impairment of property, plant and equipment, the first $20 million of impairment will be allocated to the revaluation surplus so only $23 million would have reduced operating profits and should be added back. In relation to the pension scheme, the remeasurement component can be ignored as it is neither a cash flow nor an expense to operating profits. Cash contributions should be deducted, though, as these represent an operating cash payment ultimately to be received by Moyes' employees. Benefits paid are a cash outflow for the pension scheme rather than Moyes and so should be ignored.

The movements on receivables, payables and inventory are adjusted so that the timing differences between when cash is paid or received and when the items are accrued in the financial statements are accounted for. Inventory is measured at the lower of cost and net realisable value. The inventory has suffered an overall loss of $6 million (Dinar 80 million/5 – Dinar 60 million/6). Of this, $2.7 million is an exchange loss (Dinar 80 million/5 – Dinar 80 million/6) and $3.3 million is an impairment (Dinar (80 – 60) million/6). Neither of these are cash flows and would be added back to profits in the reconciliation. However, the loss of $6 million should also be adjusted in the movement of the inventory as a non-cash flow. The net effect on the statement of cash flows will be nil.

(b) When the parent company acquires or sells a subsidiary during the financial year, cash flows arising from the acquisition or disposal are presented within investing activities. In relation to Davenport, no cash consideration has been paid during the current year since the consideration consisted of a share for share exchange and some deferred cash. The deferred cash would be presented as a negative cash flow within investing activities but only when paid in two years' time.

This does not mean that there would be no impact on the current year's statement of cash flows. On gaining control, Moyes would consolidate 100% of the assets and liabilities of Davenport which would presumably include some cash or cash equivalents at the date of acquisition. These would be presented as a cash inflow at the date of acquisition net of any overdrafts held at acquisition. Adjustments would also need to be made to the opening balances of assets and liabilities by adding the fair values of the identifiable net assets at acquisition to the respective balances. This would be necessary to ensure that only the cash flow effects are reported in the consolidated statement of cash flows. Fair value adjustments to assets and liabilities could also have deferred tax effects which would need adjusting so that only cash payments for tax are included within the statement of cash flows. Dividends received by Moyes from Davenport are not included in the consolidated statement of cash flows since cash has in effect been transferred from one group member to another. The non-controlling interest's share of the dividend would be presented as a cash outflow in financing activities.

On the disposal of Barham, the net assets at disposal, including goodwill, are removed from the consolidated financial statements. Since Barham is overdrawn, this will have a positive cash flow effect for the group. The overdraft will be added to the proceeds (less any cash and cash equivalents at disposal) to give an overall inflow presented in investing activities. Care would once again be necessary to ensure that all balances at the disposal date are removed from the corresponding assets and liabilities so that only cash flows are recorded within the consolidated statement of cash flows.

(c) IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* defines a discontinued operation as a component of an entity which either has been disposed of or is classified as held for sale, and:

(i) Represents a separate major line of business or geographical area of operations;

(ii) Is a single co-ordinated plan to dispose of a separate major line or area of operations; and

(iii) Is a subsidiary acquired exclusively for resale.

Both entities would be components of the Moyes group since their operations and cash flows are clearly distinguishable for reporting purposes. Barham has been sold during the year but there appears to be other subsidiaries which operate in similar geographical regions and produce similar products. Little guidance is given as to what would constitute a separate major line of business or geographical area of operations. The definition is subjective and the directors should consider factors such as materiality and relevance before determining whether Barham should be presented as discontinued or not.

To be classified as held for sale, a sale has to be highly probable and the entity should be available for sale in its present condition. At face value, Watson would not appear to meet this definition as no sales transaction is to take place.

IFRS 5 does not explicitly extend the requirements for held for sale to situations where control is lost. However, the International Accounting Standards Board (IASB) have confirmed that in instances where control is lost, the subsidiaries' assets and liabilities should be derecognised. Loss of control is a significant economic event and fundamentally changes the investor – investee relationship. Therefore situations where the parent is committed to lose control should trigger a reclassification as held for sale. Whether this should be extended to situations where control is lost to other causes would be judgemental. It is possible therefore that Watson should be classified as held for sale but to be classified as a discontinued operation, Watson would need to represent a separate major line of business or geographical area of operation.

Part B

(i) Deferred consideration

When calculating goodwill, IFRS 3 *Business Combinations* states that purchase consideration should be measured at fair value. For deferred cash consideration, this will be the present value of the cash flows. This amounts to \$29 million (\$32m × 0.907). Goodwill arising on acquisition should be increased by \$29 million and a corresponding liability should be recognised:

DEBIT Goodwill	\$29 million	
CREDIT Liability		\$29 million

Interest of \$1.5 million (\$29m × 5%) should be recorded. This is charged to the statement of profit or loss and increases the carrying amount of the liability:

DEBIT Finance costs	\$1.5 million	
CREDIT Liability		\$1.5 million

Property, plant and equipment (PPE)

During the measurement period IFRS 3 states that adjustments should be made retrospectively if new information is determined about the value of consideration transferred, the subsidiary's identifiable net assets, or the non-controlling interest. The measurement period ends no later than 12 months after the acquisition date.

The survey detailed that Chandler's PPE was overvalued by \$10 million as at the acquisition date. It was received four months after the acquisition date and so this revised valuation was received during the measurement period. As such, goodwill at acquisition should be recalculated. As at the acquisition date, the carrying amount of PPE should be reduced by \$10 million and the carrying amount of goodwill increased by \$10 million:

DEBIT Goodwill	\$10 million	
CREDIT PPE		\$10 million

NCI

The NCI at acquisition was valued at \$34 million but it should have been valued at \$32 million ((\$170m – \$10m PPE adjustment) × 20%). Both NCI at acquisition and goodwill at acquisition should be reduced by \$2 million:

DEBIT NCI	\$2 million	
CREDIT Goodwill		\$2 million

Goodwill

Goodwill arising on the acquisition of Chandler should have been calculated as follows:

	\$m
Fair value of consideration (\$150m + \$29m)	179
NCI at acquisition	32
Fair value of identifiable net assets acquired	(160)
Goodwill at acquisition	51

Goodwill impairment

According to IAS 36 *Impairment of Assets*, a cash-generating unit to which goodwill is allocated should be tested for impairment annually by comparing its carrying amount to its recoverable amount. As goodwill has been calculated using the proportionate method, then this must be grossed up to include the goodwill attributable to the NCI.

	$m	$m
Goodwill	51.0	
Notional NCI ($51m × 20/80)	12.8	
Total notional goodwill		63.8
Net assets at reporting date:		
Fair value at start of period	160.0	
Profit for period	52.0	
		212.0
Total carrying amount of assets		275.8
Recoverable amount		(250.0)
Impairment		25.8

The impairment is allocated against the total notional goodwill. The NCI share of the goodwill has not been recognised in the consolidated financial statements and so the NCI share of the impairment is also not recognised. The impairment charged to profit or loss is therefore $20.6 million ($25.8m × 80%) and this expense is all attributable to the equity holders of the parent company.

DEBIT Operating expenses	$20.6 million	
CREDIT Goodwill		$20.6 million

The carrying amount of the goodwill relating to Chandler at the reporting date will be $30.4 million ($51m acquisition – $20.6m impairment).

(ii) **Doyle**

The share sale results in Hill losing control over Doyle. The goodwill, net assets and NCI of Doyle must be derecognised from the consolidated statement of financial position. The difference between the proceeds from the disposal (including the fair value of the shares retained) and these amounts will give rise to a $47 million profit on disposal. This is calculated as follows:

	$m	$m
Proceeds	140	
Fair value of remaining interest	300	
		440
Goodwill at disposal		(50)
Net assets at disposal		(590)
NCI:		
At acquisition	215	
NCI % of post acquisition profit (40% × ($590m – $510m))	32	
NCI at disposal		247
Profit on disposal		47

After the share sale, Hill owns 40% of Doyle's shares and has the ability to appoint two of the six members of Doyle's board of directors. IAS 28 *Investments in Associates and Joint Ventures* states that an associate is an entity over which an investor has significant influence. Significant influence is presumed when the investor has a shareholding of between 20 and 50%. Representation on the board of directors provides further evidence that significant influence exists.

Therefore, the remaining 40% shareholding in Doyle should be accounted for as an associate. It will be initially recognised at its fair value of $300 million and accounted for using the equity method. This means that the group recognises its share of the associate's profit after tax, which equates to $24.6 million ($123m × 6/12 × 40%). As at the reporting date, the associate will be carried at $324.6 million ($300m + $24.6m) in the consolidated statement of financial position.

(iii) **Convertible bond**

Hill has issued a compound instrument because the bond has characteristics of both a financial liability (an obligation to repay cash) and equity (an obligation to issue a fixed number of Hill's own shares). IAS 32 *Financial Instruments: Presentation* specifies that compound instruments must be split into:

- A liability component (the obligation to repay cash); and
- An equity component (the obligation to issue a fixed number of shares).

The split of the liability component and the equity component at the issue date is calculated as follows:

- The liability component is the present value of the cash repayments, discounted using the market rate on non-convertible bonds;
- The equity component is the difference between the cash received and the liability component at the issue date.

The initial carrying amount of the liability should have been measured at $17.9 million, calculated as follows:

Date	*Cash flow*	*Discount rate*	*Present value*
	$m		$m
30 September 20X6	0.8	0.909	0.73
30 September 20X7	20.8	0.826	17.18
			17.91

The equity component should have been initially measured at $2.1 million ($20m – $17.9m). The adjustment required is:

DEBIT Non-current liabilities	$2.1m	
CREDIT Equity		$2.1m

The equity component remains unchanged. After initial recognition, the liability is measured at amortised cost, as follows:

1 October 20X5	*Finance charge (10%)*	*Cash paid*	*30 September 20X6*
$m	$m	$m	$m
17.9	1.8	(0.8)	18.9

The finance cost recorded for the year was $0.8 million and so must be increased by $1.0 million ($1.8m – $0.8m).

DEBIT Finance costs	$1.0m	
CREDIT Non-current liabilities		$1.0m

The liability has a carrying amount of $18.9 million as at the reporting date.