ACCOUNTING STANDARDS – PRACTICE QUESTIONS **Compiled for JMC**
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ADVANCE BUSINESS REPORTING - PRACTICE QUESTIONS

1.) Question - LKAS 36 Impairment of Assets

At 31 May 2010 Cate held an investment in and had a significant influence over Bates, a public limited company.

Cate had carried out an impairment test in respect of its investment in accordance with the procedures prescribed in LKAS 36, Impairment of assets. Cate argued that fair value was the only measure applicable in this case as value-in-use was not determinable as cash flow estimates had not been produced. Cate stated that there were no plans to dispose of the shareholding and hence there was no binding sale agreement. Cate also stated that the quoted share price was not an appropriate measure when considering the fair value of Cate's significant influence on Bates. Therefore, Cate estimated the fair value of its interest in Bates through application of two measurement techniques; one based on earnings multiples and the other based on an option–pricing model. Neither of these methods supported the existence of an impairment loss as of 31 May 2010.

Discuss the appropriateness of the conclusion reached by Cate. (5 marks)

<u>Answer</u>

Cate's position for an investment where the investor has significant influence and its method of calculating fair value can be challenged.

An asset's recoverable amount represents its greatest value to the business in terms of its cash flows that it can generate i.e. the higher of fair value less costs to sell (which is what the asset can be sold for less direct selling expenses) and value in use (the cash flows that are expected to be generated from its continued use including those from its ultimate disposal). The asset's recoverable amount is compared with its carrying value to indicate any impairment. Both net selling price (NSP) and value in use can be difficult to determine. However it is not always necessary to calculate both measures, as if the NSP or value in use is greater than the carrying amount, there is no need to estimate the other amount.

It should be possible in this case to calculate a figure for the recoverable amount. Cate's view that market price cannot reflect the fair value of significant holdings of equity such as an investment in an associate is incorrect as LKAS 36 prescribes the method of conducting the impairment test in such circumstances by stating that if there is no binding sale agreement but an asset is traded in an active market, fair value less costs to sell is the asset's market price less the costs of disposal. Further, the appropriate market price is usually the current bid price.

Additionally the compliance with LKAS 28, Investments in associates is in doubt in terms of the non-applicability of value in use when considering impairment. LKAS 28 explains that in determining the value in use of the investments, an entity estimates:

(i) its share of the present value of the estimated future cash flows expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; or
(ii) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Estimates of future cash flows should be produced. These cash flows are then discounted to present value hence giving value in use.

It seems as though Cate wishes to avoid an impairment charge on the investment.

2.) Question - LKAS 36 Impairment of Assets

(i) Estoil is an international company providing parts for the automotive industry. It operates in many different jurisdictions with different currencies. During 2014, Estoil experienced financial difficulties marked by a decline in revenue, a reorganisation and restructuring of the business and it reported a loss for the year. An impairment test of goodwill was performed but no impairment was recognised. Estoil applied one discount rate for all cash flows for all cash generating units (CGUs), irrespective of the currency in which the cash flows would be generated. The discount rate used was the weighted average cost of capital (WACC) and Estoil used the 10-year government bond rate for its jurisdiction as the risk free rate in this calculation. Additionally, Estoil built its model using a forecast denominated in the functional currency of the parent company. Estoil felt that any other approach would require a level of detail which was unrealistic and impracticable. Estoil argued that the different CGUs represented different risk profiles in the short term, but over a longer business cycle, there was no basis for claiming that their risk profiles were different.

(ii) Fariole specialises in the communications sector with three main CGUs. Goodwill was a significant component of total assets. Fariole performed an impairment test of the CGUs. The cash flow projections were based on the most recent financial budgets approved by management. The realised cash flows for the CGUs were negative in 2014 and far below budgeted cash flows for that period. The directors had significantly raised cash flow forecasts for 2015 with little justification. The projected cash flows were calculated by adding back depreciation charges to the budgeted result for the period with expected changes in working capital and capital expenditure not taken into account.

Required:

Discuss the acceptability of the above accounting practices under LKAS 36 Impairment of Assets. (10 marks)

<u>Answer</u>

(i) The discount rate used by Estoil has not been calculated in accordance with the requirements of LKAS 36 Impairment of Assets. According to LKAS 36, the future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. LKAS 36 requires the present value to be translated using the spot exchange rate at the date of the value in use calculation. Furthermore, the currency in which the estimated cash flows are denominated affects many of the inputs to the WACC calculation, including the risk free interest rate.

Estoil has used the 10-year government bond rate for its jurisdiction as the risk free rate in the calculation of the discount rate. As government bond rates differ between countries due to different expectations about future inflation, value in use could be calculated incorrectly due to the disparity between the expected inflation reflected in the estimated cash flows and the risk free rate.

According to LKAS 36, the discount rate should reflect the risks specific to the asset. Accordingly, one discount rate for all the CGUs does not represent the risk profile of each CGU. The discount rate generally should be determined using the WACC of the CGU or of the company of which the CGU is currently part. Using a company's WACC for all CGUs is appropriate only if the specific risks associated with the specific CGUs do not diverge materially from the remainder of the group. In the case of Estoil, this is not apparent.

(ii) It appears that the cash flow forecasts were not prepared based on the requirements of LKAS 36. LKAS 36 states that cash flow projections used in measuring value in use shall be based on reasonable and supportable assumptions which represent management's best estimate of the range of economic conditions which will exist over the remaining useful life of the asset. LKAS 36 also states that management must assess the reasonableness of the assumptions by examining the causes of differences between past cash flow projections and actual cash. Management should ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes. Despite the fact that the realised cash flows for 2014 were negative and far below projected cash flows, the directors had significantly raised budgeted cash flows for 2015 without justification. There are serious doubts about Fariole's ability to establish realistic budgets.

According to LKAS 36, estimates of future cash flows should include:

(i) projections of cash inflows from the continuing use of the asset;

(ii) projections of cash outflows which are necessarily incurred to generate the cash inflows from continuing use of the asset; and

(iii) net cash flows to be received (or paid) for the disposal of the asset at the end of its useful life.

LKAS 36 states that projected cash outflows should include those required for the day-to-day servicing of the asset which includes future cash outflows to maintain the level of economic benefits expected to arise from the asset in its current condition. It is highly unlikely that no investments in working capital or operating assets would need to be made to maintain the assets of the CGUs in their current condition. Therefore, the cash flow projections used by Fariole are not in compliance with LKAS 36.

3.) Question - LKAS 36 Impairment of Assets

Canto acquired a cash-generating unit (CGU) several years ago but, at 28 February 2017, the directors of Canto were concerned that the value of the CGU had declined because of a reduction in sales due to new competitors entering the market. At 28 February 2017, the carrying amounts of the assets in the CGU before any impairment testing were:

	($m)
Goodwill	3
Property, plant and equipment	10
Other assets	19
Total	32

The fair values of the property, plant and equipment and the other assets at 28 February 2017 were $10 million and $17 million respectively and their costs to sell were $100,000 and $300,000 respectively.

The CGU's cash flow forecasts for the next five years are as follows:

Date year ended	Pre-tax cash flow	Post-tax cash flow
	($m)	($m)
28 February 2018	8	5
28 February 2019	7	5
28 February 2020	5	3
28 February 2021	3	1·5
28 February 2022	13	10

The pre-tax discount rate for the CGU is 8% and the post-tax discount rate is 6%. Canto has no plans to expand the capacity of the CGU and believes that a reorganisation would bring cost savings but, as yet, no plan has been approved.

The directors of Canto need advice as to whether the CGU's value is impaired.

The following extract from a table of present value factors has been provided.

Year	Discount rate 6%	Discount rate 8%	
1	0·9434	0·9259	
2	0·8900	0·8573	
3	0·8396	0·7938	
4	0·7921	0·7350	
5	0·7473	0·6806	(8 marks)

Answer

LKAS 36 Impairment of Assets requires that assets be carried at no more than their carrying amount. Therefore entities should test all assets within the scope of the standard if there is potential impairment when indicators of impairment exist. If fair value less costs of disposal or value in use is more than carrying amount, the asset is not impaired. It further says that in measuring value in use, the discount rate used should be the pre-tax rate which reflects current market assessments of the time value of money and the risks specific to the asset. The discount rate should not reflect risks for which future cash flows have been adjusted and should equal the rate of return which investors would require if they were to choose an investment which would generate cash flows equivalent to those expected from the asset. Therefore pre-tax cash flows and pre-tax discount rates should be used to calculate value in use. Discounting post-tax cash flows with a post-tax discount rate could give the same result in an entity were it not for any temporary differences and/or tax losses which might exist.

Date year ended	Pre-tax cash flow ($m)	Discounted cash flows ($m) at 8%
28 February 2018	8	7·41
28 February 2019	7	6·00
29 February 2020	5	3·97
28 February 2021	3	2·21
28 February 2022	13	8·85
Total		28·44

The CGU is impaired by the amount by which the carrying amount of the cash-generating unit exceeds its recoverable amount which is the higher of an asset's fair value less costs of disposal and its value in use. The fair value less costs to sell ($26·6 million) is lower than the value in use ($28·44 million). The recoverable amount is therefore $28·44 million. The carrying amount is $32 million and therefore the impairment is $3·56 million. Canto will allocate the impairment loss first to the goodwill and then to other assets of the unit pro rata on the basis of the carrying amount of each asset in the cash-generating unit. Consequently, the entity will allocate $3 million to goodwill and then allocate $0·56 million on a pro rata basis to PPE (0·56 x 10/29 = $0·19 million) and other assets (0·56 x 19/29 = $0·37 million). This would mean that the carrying amounts would be $9·81 million and $18·63 million respectively.

However, when allocating the impairment loss, the carrying amount of an asset cannot be reduced below its fair value less costs to sell. The fair value less costs to sell of the CGU's assets is $9·9 million (PPE) and $16·7 million (other assets). Therefore the carrying amounts of the assets of the CGU after impairment will be PPE $9·9 million and other assets $18·54 million as the excess impairment of $0·09 million on PPE will be allocated to other assets

4.) Question - LKAS 24 Related Party Disclosures

Alexandra PLC has a two-tier board structure consisting of a management and a supervisory board.

Alexandra remunerates its board members as follows:

– Annual base salary

– Variable annual compensation (bonus)

– Share options

In the group financial statements, within the related parties note under LKAS 24 Related Party Disclosures, Alexandra disclosed the total remuneration paid to directors and non-executive directors and a total for each of these boards. No further breakdown of the remuneration was provided.

The management board comprises both the executive and non-executive directors. The remuneration of the non-executive directors, however, was not included in the key management disclosures.

Some members of the supervisory and management boards are of a particular nationality.

Alexandra was of the opinion that in that jurisdiction, it is not acceptable to provide information about remuneration that could be traced back to individuals. Consequently, Alexandra explained that it had provided the related party information in the annual accounts in an ambiguous way to prevent users of the financial statements from tracing remuneration information back to specific individuals.

Answer

The exclusion of the remuneration of the non-executive directors from key management personnel disclosures did not comply with the requirements of LKAS 24 which defines key management personnel as those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity. Alexandra did not comply with paragraph 16 of the standard, which also requires key management personnel remuneration to be analysed by category. The explanation of Alexandra is not acceptable.

LKAS 24 states that an entity should disclose key management personnel compensation in total and for each of the following categories:

(a) short-term employee benefits;

(b) post-employment benefits;

(c) other long-term benefits;

(d) termination benefits; and

(e) share-based payment.

Providing such disclosure will not give information on what individual board members earn as only totals for each category need be disclosed, hence will not breach any cultural protocol. However legislation from local government and almost certainly local corporate governance will require greater disclosure for public entities such as Alexandra.

By not providing an analysis of the total remuneration into the categories prescribed by the standard, the disclosure of key management personnel did not comply with the requirements of LKAS 24.

5.) Question - LKAS 24 Related Party Disclosures

At 30 November 2016, three people own the shares of Suntory. The finance director owns 60%, and the operations director owns 30%. The third owner is a passive investor who does not help manage the entity. All ordinary shares carry equal voting rights. The wife of the finance director is the sales director of Suntory. Their son is currently undertaking an internship with Suntory and receives a salary of $30,000 per annum, which is normal compensation.

The finance director and sales director have set up an investment company, Baleel. They jointly own Baleel and their shares in Baleel will eventually be transferred to their son when he has finished the internship with Suntory.

In addition, on 1 June 2016 Suntory obtained a bank loan of $500,000 at a fixed interest rate of 6% per annum. The loan is to be repaid on 30 November 2017. Repayment of the principal and interest is secured by a guarantee registered in favour of the bank against the private home of the finance director.

The directors of Suntory require advice on the identification and disclosure of the company's related parties in preparing its separate financial statements for the year ending 30 November 2016. (7 marks)

Answer

LKAS 24 Related Party Disclosures requires an entity's financial statements to contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

A person or a close member of that person's family is related to a reporting entity if that person:

(i) has control or joint control over the reporting entity;

(ii) has significant influence over the reporting entity; or

(iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

With regards to Suntory, the finance director is a related party, as he owns more than half of the voting power (60%). In the absence of evidence to the contrary, he controls Suntory and is a member of the key management personnel. The sales director is also a related party of Suntory as she is a member of the key management personnel and is a close member (spouse) of the family of the finance director. Their son is a related party of Suntory as he is a close member (son) of their family. The operations director is also a related party as he owns more than 20% of the voting power in Suntory. In the absence of evidence to the contrary, the operations director has significant influence over Suntory and is a member of the key management personnel.

An entity is related to a reporting entity if the entity is controlled or jointly controlled by a person identified as a related party.

Hence, Baleel is a related party of Suntory. Baleel is controlled by related parties, the finance and sales directors, for the benefit of a close member of their family, i.e. their son.

In the absence of evidence to the contrary, the third owner of the shares is not a related party. The person is a passive investor who does not appear to exert significant influence over Suntory. The loan from the bank, which has been guaranteed by the finance director, will be disclosed as such in the financial statements. Disclosure of personal guarantees given by directors in respect of borrowings by the reporting entity should be disclosed in the notes to the financial statements.

6.) Question - LKAS 12 Income tax

Cate is an entity in the software industry. Cate had incurred substantial losses in the financial years 31 May 2004 to 31 May 2009.

In the financial year to 31 May 2010 Cate made a small profit before tax. This included significant non-operating gains. In 2009, Cate recognised a material deferred tax asset in respect of carried forward losses, which will expire during 2012. Cate again recognised the deferred tax asset in 2010 on the basis of anticipated performance in the years from 2010 to 2012, based on budgets prepared in 2010.

The budgets included high growth rates in profitability. Cate argued that the budgets were realistic as there were positive indications from customers about future orders. Cate also had plans to expand sales to new markets and to sell new products whose development would be completed soon. Cate was taking measures to increase sales, implementing new programs to improve both productivity and profitability. Deferred tax assets less deferred tax liabilities represent 25% of shareholders' equity at 31 May 2010. There are no tax planning opportunities available to Cate that would create taxable profit in the near future.

Discuss whether the accounting treatments proposed by the company are acceptable under SLFRS's

Answer

A deferred tax asset should be recognised for deductible temporary differences, unused tax losses and unused tax credits to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised. The recognition of deferred tax assets on losses carried forward does not seem to be in accordance with LKAS 12 Income Taxes. Cate is not able to provide convincing evidence that sufficient taxable profits will be generated against which the unused tax losses can be offset. According to LKAS 12 the existence of unused tax losses is strong evidence that future taxable profit may not be available against which to offset the losses. Therefore when an entity has a history of recent losses, the entity recognizes deferred tax assets arising from unused tax losses only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available. As Cate has a history of recent losses and as it does not have sufficient taxable temporary differences, Cate needs to provide convincing other evidence that sufficient taxable profit would be available against which the unused tax losses could be offset. The unused tax losses in question did not result from identifiable causes, which were unlikely to recur (LKAS 12) as the losses are due to ordinary business activities. Additionally there are no tax planning opportunities available to Cate that would create taxable profit in the period in which the unused tax losses could be offset (LKAS 12).

Thus at 31 May 2010 it is unlikely that the entity would generate taxable profits before the unused tax losses expired. The improved performance in 2010 would not be indicative of future good performance as Cate would have suffered a net loss before tax had it not been for the non-operating gains.

Cate's anticipation of improved future trading could not alone be regarded as meeting the requirement for strong evidence of future profits. When assessing the use of carry-forward tax losses, weight should be given to revenues from existing orders or confirmed contracts rather than those that are merely expected from improved trading. Estimates of future taxable profits can rarely be objectively verified. Thus the recognition of deferred tax assets on losses carried forward is not in accordance with LKAS 12 as Cate is not able to provide convincing evidence that sufficient taxable profits would be generated against which the unused tax losses could be offset.

7.) Question - LKAS 12 Income tax

Spamgate also has a majority holding in Rooble which operates in an overseas country which is currently in an economic crisis. Compared to the dollar, the exchange rate in the country has dropped more than 35% in the current financial year and the inflation rate is 12%. Rooble had started to build a commercial shopping centre but, because of the difficult economic environment, it had ceased the building work. However, the directors of Spamgate are currently negotiating the sale of the commercial centre on Rooble's behalf and anticipate that a significant profit will be made on the sale compared to its carrying amount. Rooble had suffered significant trading losses in recent years and in its financial statements to 31 May 2018. This had led to negative equity and unused tax losses from trading. The tax losses can only be offset against profit arising from trading.

Spamgate has recognised a deferred tax asset in its consolidated financial statements relating to the unused tax losses of the subsidiary. However, there was no disclosure of the evidence supporting the recognition of the deferred tax asset in the draft consolidated financial statements.

The directors would like advice on their recognition of the deferred tax asset in the financial statements. (8 marks)

Answer

LKAS 12 Income Taxes states that deferred tax assets for deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint arrangements, are only recognised to the extent that it is probable that the temporary difference will reverse against available profits.

The estimate of probable future taxable profit may include the sale of some of an entity's assets for more than their carrying amount, if there is sufficient evidence that it is probable that this will be achieved. In the case of Rooble, there is a possibility that the commercial centre may be sold for more than its carrying amount and thus can be included in the calculation of future taxable profit. However, when assessing the availability of taxable profits against which a deductible temporary difference can be utilised, Spamgate should consider whether tax law restricts the usage of those tax losses. If tax law restricts the utilization of losses to deduction against income of a specific type, a deductible temporary difference is assessed in combination only with other deductible temporary differences of the appropriate type. Thus in this case, the tax losses can only be utilised against trading profits and not against the potential gain on the sale of the commercial centre.

In evaluating whether it will have sufficient taxable profit in future periods, Spamgate should compare the deductible temporary differences with future taxable profit which excludes tax deductions resulting from the reversal of those deductible temporary differences. It should ignore taxable amounts arising from deductible temporary differences which are expected to originate in future periods.

According to LKAS 12, the existence of unused losses is a strong evidence that future taxable profit may not be available. Rooble has a history of recent losses, and therefore, it has to provide convincing evidence that sufficient taxable profit will be available to utilise the unused tax losses. However, there was no convincing evidence disclosed in the financial statements showing that the unused tax losses could *be utilised by the entities in future. The country in which Rooble operates is in economic crisis including a significant decline in the currency's exchange rate and high inflation. Spamgate has no convincing evidence that this situation will reverse in the foreseeable future. The conclusion would appear to be that, based on the challenging economic environment and the fact that the construction of the commercial centre was postponed, even though there is a possibility of its sale, there is no convincing evidence that the tax losses could be utilised by Rooble in the near future. Therefore, no deferred tax asset for the unused tax losses should have been recognised.*

8.) Question - SLFRS 16 Leases

Carsoon Co is a company which manufactures and retails motor vehicles. It also constructs premises for third parties. The entity enters into lease agreements with the public for its motor vehicles. The agreements are normally for a three-year period. The customer decides how to use the vehicle within certain contractual limitations. The maximum mileage per annum is specified at 10,000 miles without penalty and the vehicle cannot be used in other jurisdictions. Carsoon is responsible for the maintenance of the vehicle and insists that the vehicle cannot be modified in any way. At the end of the three-year contract, the customer can purchase the vehicle at a price which will be above the market value, or alternatively hand it back to Carsoon. If the vehicle is returned, Carsoon will then sell the vehicle on to the public through one of its retail outlets. These sales of vehicles are treated as investing activities in the statement of cash flows. The directors of Carsoon wish to know how the leased vehicles should be accounted for, from the commencement of the lease to the final sale of the vehicle, in the financial statements including the statement of cash flows

Answer

Under SLFRS 16 Leases, from the view of the lessor a lease is classified as a finance lease if it transfers substantially all of the risks and rewards incident to ownership. All other leases are classified as operating leases. Classification is made at the inception of the lease. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form.

In this case, the leases are operating leases. The lease is unlikely to transfer ownership of the vehicle to the lessee by the end of the lease term as the option to purchase the vehicle is at a price which is higher than fair value at the end of the lease term. The lease term is not for the major part of the economic life of the asset as vehicles normally have a length of life of more than three years and the maximum unpenalised mileage is 10,000 miles per annum. Additionally, the present value of the minimum lease payments is unlikely to be substantially all of the fair value of the leased asset as the price which the customer can purchase the vehicle is above market value, hence the lessor does not appear to have received an acceptable return by the end of the lease. Carsoon also stipulates the maximum mileage and type of usage, as the vehicles cannot be used in other jurisdictions. This would appear to indicate that the risks and rewards remain with Carsoon. Finally, Carsoon maintains the vehicles which again indicates that the risks and rewards remain with the entity.

Carsoon should account for vehicles held for rental in operating leases as property, plant and equipment (PPE) and depreciate them taking into account the expected residual value. The rental payments should go to profit or loss. Where an item of property, plant and equipment ceases to be rented and becomes held for sale, it should be transferred to inventory at its carrying amount. The proceeds from the sale of such *assets should be recognised as revenue in accordance with SLFRS 15 Revenue from Contracts with Customers. SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations does not apply when assets which are held for sale in the ordinary course of business are transferred to inventories.*

LKAS 7 Statements of Cash Flows states that payments from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events which enter into the determination of profit or loss. Therefore cash payments made to acquire assets formerly held for rental and subsequently held for sale should be treated as cash flows from operating activities and not investing activities.

9.) Question - SLFRS 16 Leases

Previous leasing standards have been criticised about the lack of information they required to be disclosed on leasing transactions. These concerns were usually expressed by investors and so SLFRS 16 Leases was issued in response to these criticisms.

Required:

(i) Discuss some of the key changes to financial statements which investors will see when companies apply the lessee accounting requirements in SLFRS 16. (6 marks)

(ii) For a company with significant off-balance sheet leases, discuss the likely impact that SLFRS 16 will have generally on accounting ratios and particularly on:

– Earnings before interest and tax to interest expense (interest cover);

– Earnings before interest and tax to capital employed (return on capital employed);

– Debt to earnings before interest, tax, depreciation and amortisation (EBITDA). (6 marks)

Answer

(i) SLFRS 16 Leases introduces a single lessee accounting model and should reduce the number of off-balance sheet leases. Upon lease commencement, a lessee recognises a right-of-use asset and a lease liability. After lease commencement, a lessee measures the right-of-use asset using a cost model less accumulated depreciation and accumulated impairment. The lease liability is initially measured at the present value of the lease payments payable over the lease term, discounted at the rate implicit in the lease if that can be readily determined. Lease liabilities include only economically unavoidable payments.

Investors should bear in mind that some sectors and some companies will be more affected than others. As a result, companies with previous material off-balance sheet leases will report higher assets and financial liabilities. The standard will reduce complexity in financial statements as it should allow comparisons to be made between those companies who lease assets and those who borrow to buy assets.

Investors will no longer have to estimate the assets and liabilities resulting from off-balance sheet leases when calculating ratios as there should be fewer off-balance sheet leases. SLFRS 16 will result in more *information about leases both on the statement of financial position and in the notes and will provide a more accurate reflection of the economics of leases. The carrying amount of lease assets will typically reduce more quickly than the carrying amount of lease liabilities. This will result in a reduction in reported equity for companies with previous material off-balance sheet leases.*

SLFRS 16 requires a lessee to disclose lease liabilities separately from other liabilities as a separate line item, or together with other similar liabilities, in a manner which is relevant to understanding the lessee's financial position. A lessee will also split lease liabilities into current and non-current portions, based on the timing of payments.

(ii) The recognition of an asset which was previously unrecognised will result in a higher asset base, which will affect ratios such as asset turnover. The recognition of a liability which was previously unrecognised will result in higher financial liabilities, which will affect gearing. The recognition of depreciation and interest instead of operating lease expense will result in higher operating profit because interest is typically excluded from operating expenses and will affect performance ratios. Similarly, profit measures which exclude interest and depreciation but previously included operating lease expense, such as EBITDA, will be higher under SLFRS 16.

Interest cover: there will be an increase in the earnings measure (i.e. EBITDA) which will not be proportionate to the increase in interest. The change in the ratio will depend on the characteristics of the lease portfolio.

Return on capital employed: it is likely that ROCE will be lower under SLFRS 16 because the increase in operating profit is unlikely to be proportionate to the increase in capital employed.

Debt to EBITDA: ratio of debt to EBITDA is likely to be higher because debt will increase by more than the increase in earnings. Debt will increase because of the fact that lease liabilities will be recognised on the statement of financial position. For companies which have material off-balance sheet leases, SLFRS 16 is expected to result in higher profit before interest because a company presents the implicit interest in lease payments for former off-balance sheet leases as part of finance costs. Previously, the entire expense related to off-balance sheet leases was included as part of operating expenses. The size of the increase in operating profit, and finance costs, will depend on the significance of leasing activities to the company.

10.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

(a) The difference between debt and equity in an entity's statement of financial position is not easily distinguishable for preparers of financial statements. Some financial instruments may have both features, which can lead to inconsistency of reporting. The International Accounting Standards Board (IASB) has agreed that greater clarity may be required in its definitions of assets and liabilities for debt instruments. It is thought that defining the nature of liabilities would help the IASB's thinking on the difference between financial instruments classified as equity and liabilities.

Required:

(i) Discuss the key classification differences between debt and equity under International Financial Reporting Standards.

Note: Examples should be given to illustrate your answer. (9 marks)

(ii) Explain why it is important for entities to understand the impact of the classification of a financial instrument as debt or equity in the financial statements. (5 marks)

Answer

(i) LKAS 32 Financial Instruments: Presentation establishes principles for presenting financial instruments as liabilities or equity. To determine whether a financial instrument should be classified as debt or equity, LKAS 32 uses principles-based definitions of a financial liability and of equity. In contrast to the requirements of generally accepted accounting practice in many jurisdictions around the world, LKAS 32 does not classify a financial instrument as equity or financial liability on the basis of its legal form. The key feature of debt is that the issuer is obliged to deliver either cash or another financial asset to the holder. The contractual obligation may arise from a requirement to repay principal or interest or dividends.

Such a contractual obligation may be established explicitly or indirectly through the terms of the agreement. For example, a bond which requires the issuer to make interest payments and redeem the bond for cash is classified as debt. In contrast, equity is any contract which evidences a residual interest in the entity's assets after deducting all of its liabilities. A financial instrument is an equity instrument only if the instrument includes no contractual obligation to deliver cash or another financial asset to another entity and if the instrument will or may be settled in the issuer's own equity instruments. For example, ordinary shares, where all the payments are at the discretion of the issuer, are classified as equity of the issuer. The classification is not quite as simple as it seems. For example, preference shares required to be converted into a fixed number of ordinary shares on a fixed date or on the occurrence of an event which is certain to occur, should be classified as equity.

A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. The classification of this type of contract is dependent on whether there is variability in either the number of equity shares delivered or variability in the amount of cash or financial assets received. A contract which will be settled by the entity receiving or delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. However, if there is any variability in the amount of cash or own equity instruments which will be delivered or received, then such a contract is a financial asset or liability as applicable.

For example, where a contract requires the entity to deliver as many of the entity's own equity instruments as are equal in value to a certain amount of cash, the holder of the contract would be indifferent whether it received cash or shares to the value of that amount. Thus this contract would be treated as debt.

Other factors, which may result in an instrument being classified as debt, are:

– redemption is at the option of the instrument holder

– there is a limited life to the instrument

– redemption is triggered by a future uncertain event which is beyond the control of both the holder and issuer of the instrument

– dividends are non-discretionary

Similarly, other factors, which may result in the instrument being classified as equity, are whether the shares are non-redeemable, whether there is no liquidation date or where the dividends are discretionary.

(ii) *The classification of a financial instrument by the issuer as either debt or equity can have a significant impact on the entity's gearing ratio, reported earnings, and debt covenants. Equity classification can avoid such impact but may be perceived negatively if it is seen as diluting existing equity interests. The distinction between debt and equity is also relevant where an entity issues financial instruments to raise funds to settle a business combination using cash or as part consideration in a business combination. Understanding the nature of the classification rules and potential effects is critical for management and must be borne in mind when evaluating alternative financing options. Liability classification normally results in any payments being treated as interest and charged to profit or loss, which may affect the entity's ability to pay dividends on its equity shares.*

11.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

The directors of Avco, a public limited company, are reviewing the financial statements of two entities which are acquisition targets, Cavor and Lidan.They have asked for clarification on the treatment of the following financial instruments within the financial statements of the entities.

Cavor has two classes of shares: A and B shares. A shares are Cavor's ordinary shares and are correctly classed as equity. B shares are not mandatorily redeemable shares but contain a call option allowing Cavor to repurchase them. Dividends are payable on the B shares if, and only if, dividends have been paid on the A ordinary shares. The terms of the B shares are such that dividends are payable at a rate equal to that of the A ordinary shares. Additionally, Cavor has also issued share options which give the counterparty rights to buy a fixed number of its B shares for a fixed amount of $10 million. The contract can be settled only by the issuance of shares for cash by Cavor.

Lidan has in issue two classes of shares: A shares and B shares. A shares are correctly classified as equity. Two million B shares of nominal value of $1 each are in issue. The B shares are redeemable in two years' time at the option of Lidan. Lidan has a choice as to the method of redemption of the B shares. It may either redeem the B shares for cash at their nominal value or it may issue one million A shares in settlement. A shares are currently valued at $10 per share. The lowest price for Lidan's A shares since its formation has been $5 per share.

Required:

Discuss whether the above arrangements regarding the B shares of each of Cavor and Lidan should be treated as liabilities or equity in the financial statements of the respective issuing companies. (9 marks)

<u>Answer</u>

Cavor

An obligation must be established through the terms and conditions of the financial instrument. LKAS 32 uses principles-based definitions of a financial liability and of equity. LKAS 32 uses substance over form as a principle to classify a financial instrument between equity and financial liability. LKAS 32 restricts the role of 'substance' to consideration of the contractual terms of an instrument. Anything outside the contractual terms is not therefore relevant to the classification process under LKAS 32. The B shares of Cavor should be classified as equity as there is no contractual obligation to pay the dividends or to call the instrument. Dividends can only be paid on the B shares if dividends have been declared on the A shares and they are payable at the same rate as the A shares which will be variable. There is no contractual obligation to declare A share dividends. The classification of the B share options in Cavor is dependent on whether there is variability in either the number of equity shares delivered or variability in the amount of cash or financial assets received. As there is no variability and the contract will be settled by the entity issuing a fixed number of its own equity instruments in exchange for a fixed amount of cash, then the share options are classified as an equity instrument.

Lidan

The contractual obligation may arise from a requirement to repay principal or interest or dividends. Such a contractual obligation need not be explicit. It may instead be established indirectly through the terms and conditions of the financial instrument and the liability classification is not avoided by a share settlement alternative which is uneconomic in comparison to the cash obligation. The B shares of Lidan will be classified as a liability. This is because the value of the own share settlement alternative substantially exceeds that of the cash settlement option, meaning that the entity is implicitly obliged to redeem the option for a cash amount of \$1 per share. Additionally, LKAS 32 also states that where a derivative contract has settlement options, it is a financial asset or liability unless all of the settlement alternatives result in it being an equity instrument. This would also lead to the conclusion that the B shares are a financial liability.

12.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

At the start of the financial year to 30 November 2013, Coatmin gave a financial guarantee contract on behalf of one of its subsidiaries, a charitable organisation, committing it to repay the principal amount of \$60 million if the subsidiary defaulted on any payments due under a loan. The loan related to the financing of the construction of new office premises and has a term of three years. It is being repaid by equal annual instalments of principal with the first payment having been paid.

Coatmin has not secured any compensation in return for giving the guarantee, but assessed that it had a fair value of \$1·2 million. The guarantee is measured at fair value through profit or loss. The guarantee was given on the basis that it was probable that it would not be called upon. At 30 November 2014, Coatmin became aware of the fact that the subsidiary was having financial difficulties with the result that it has not paid the second instalment of principal. It is assessed that it is probable that the guarantee will now be called. However, just before the signing of the financial statements for the year ended 30 November 2014, the subsidiary secured a donation which enabled it to make the second repayment before the guarantee was called upon. It is now anticipated that the subsidiary will be able to meet the final payment. Discounting is immaterial and the fair value of the guarantee is higher than the value determined under LKAS 37 Provisions, Contingent Liabilities and Contingent Assets.

Coatmin wishes to know the principles behind accounting for the above guarantee under SLFRS and how the transaction would be accounted for in the financial records. (7 marks)

Answer

SLFRS 9 Financial Instruments says that an entity should classify all financial liabilities as subsequently measured at amortised cost using the effective interest method, except for:

(a) financial liabilities at fair value through profit or loss. Such liabilities, including derivatives which are liabilities, shall be subsequently measured at fair value.

(b) financial liabilities which arise when a transfer of a financial asset does not qualify for de-recognition or when the continuing involvement approach applies.

(c) financial guarantee contracts as defined in the standard. After initial recognition, an issuer of such a contract shall subsequently measure it at the higher of:

> *(i) the amount determined in accordance with LKAS 37 Provisions, Contingent Liabilities and Contingent Assets, and*
>
> *(ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with LKAS 18 Revenue.*

In addition, financial guarantees and loan commitments which entities choose to measure at fair value through profit or loss will have all fair value movements in profit or loss, with no transfer to OCI.

Changes in the credit risk of liabilities relating to loan commitment and financial guarantee contracts are not required to be presented in other comprehensive income.

The accounting entries on the assumption that discounting would not be material will therefore be:

1 December 2012

Dr Profit or loss $1·2 million

Cr Financial liabilities $1·2 million

To record the loss incurred in giving the guarantee.

30 November 2013

Dr Financial liabilities $0·4 million

Cr Profit or loss $0·4 million

To amortise the initial fair value over the life of the guarantee, reflecting the reduction in exposure as a result of the first repayment by the subsidiary.

30 November 2014

Dr Profit or loss $39·2 million

Cr Financial liabilities $39·2 million

To provide for the calling of the guarantee – the difference between the possible $40 million call and the carrying amount of the guarantee of $0·8 million.

Dr Financial liabilities $39·6 million

Cr Profit or loss $39·6 million

To move from the provision back to measurement at amortised initial value following event after the reporting period change in probabilities of the guarantee being called.

An event after the reporting period is an event, which could be favourable or unfavourable, which occurs between the end of the reporting period and the date when the financial statements are authorised for issue. The above is an adjusting event which is an event after the reporting period which provides further evidence of conditions which existed at the end of the reporting period.

13.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

Coatmin's creditworthiness has been worsening but it has entered into an interest rate swap agreement which acts as a hedge against a $2 million 2% bond issue which matures on 31 May 2016. The notional amount of the swap is $2 million with settlement every 12 months. The start date of the swap was 1 December 2013 and it matures on 31 May 2016. The swap is enacted for nil consideration. Coatmin receives interest at 1·75% a year and pays on the basis of the 12-month LIBOR rate. At inception, Coatmin designates the swap as a hedge in the variability in the fair value of the bond issue.

	Fair value	Fair value
	1 December 2013	30 November 2014
	$000	$000
Fixed interest bond	2,000	1,910
Interest rate swap	Nil	203

Coatmin wishes to know the circumstances in which it can use hedge accounting and needs advice on the use of hedge accounting for the above transactions. (7 marks)

<u>Answer</u>

LKAS 39 Financial Instruments: Recognition and Measurement permits hedge accounting under certain circumstances provided that the hedging relationship is:

(a) 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; and

(b) expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk as designated and documented, and effectiveness can be reliably measured; and

(c) assessed on an ongoing basis and determined to have been highly effective.

A hedging instrument is an instrument whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item. All derivative contracts with an external counterparty may be designated as hedging instruments except for some written options. A non-derivative financial asset or liability may not be designated as a hedging instrument except as a hedge of foreign currency risk. For hedge accounting purposes, only instruments which involve a party external to the reporting entity can be designated as a hedging instrument. This applies to intragroup transactions as well with the exception of certain foreign currency hedges of forecast intragroup transactions. However, they may qualify for hedge accounting in individual financial statements.

LKAS 39 requires hedge effectiveness to be assessed both prospectively and retrospectively in order to qualify for hedge accounting at the inception of a hedge and, at a minimum, at each reporting date. The changes in the fair value of the hedged item, in this case, attributable to the hedged risk must be expected to be highly effective in offsetting the changes in the fair value of the hedging instrument on a prospective basis, and on a retrospective basis where actual results are within a range of 80% to 125%. All hedge ineffectiveness is recognised immediately in profit or loss including ineffectiveness within the 80% to 125% window.

	Fair value	*Fair value*	*Changein value*
	1 December 2013	*30 November 2014*	
	\$000	*\$000*	*\$000*
Fixed interest bond	*2,000*	*1,910*	*90*
Interest rate swap	*Nil*	*203*	*203*
Effectiveness			*226% or 44%*

Therefore hedge accounting is not permitted as the results of the effectiveness test fall outside the acceptable range of 80% to 125%. The main reason for the difference in the fair value movements is likely to be Coatmin's deteriorating creditworthiness. LKAS 39 allows an entity to designate any portion of the risk in a financial asset as the hedged item. Hedge effectiveness is easier to achieve if the hedged risk matches the hedging instrument as closely as possible. Coatmin should redesignate the risk being *hedged and try to exclude the credit risk from the hedging relationship. Maybe it could hedge changes in the bond's fair value to changes in the risk free interest rate.*

14.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

Coatmin provides loans to customers and funds the loans by selling bonds in the market. The liability is designated as at fair value through profit or loss. The bonds have a fair value increase of $50 million in the year to 30 November 2014 of which $5 million relates to the reduction in Coatmin's creditworthiness.

The directors of Coatmin would like advice on how to account for this movement. (4 marks)

<u>Answer</u>

SLFRS 9 requires gains and losses on financial liabilities designated as at fair value through profit or loss to be split into the amount of change in the fair value which is attributable to changes in the credit risk of the liability, which is shown in other comprehensive income, and the remaining amount of change in the fair value of the liability which is shown in profit or loss. SLFRS 9 allows the recognition of the full amount of change in the fair value in the profit or loss only if the recognition of changes in the liability's credit risk in other comprehensive income would create an accounting mismatch in profit or loss. This is determined at initial recognition and is not reassessed. Amounts presented in other comprehensive income are not subsequently transferred to profit or loss, and the entity may only transfer the cumulative gain or loss within equity. Thus Coatmin should charge $5 million to OCI and $45 million to profit or loss.

15.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

Evolve is a real estate company, which is listed on the stock exchange and has a year end of 31 August. On 21 August 2016, Evolve undertook a scrip (bonus) issue where the shareholders of Evolve received certain rights. The shareholders are able to choose between:

(i) receiving newly issued shares of Evolve, which could be traded on 30 September 2016; or

(ii) transferring their rights back to Evolve by 10 September 2016 for a fixed cash price which would be paid on 20 September 2016.

In the financial statements at 31 August 2016, Evolve believed that the criteria for the recognition of a financial liability as regards the second option were not met at 31 August 2016 because it was impossible to reliably determine the full amount to be paid, until 10 September 2016. Evolve felt that the transferring of the rights back to Evolve was a put option on its own equity, which would lead to recording changes in fair value in profit or loss in the next financial year. Evolve disclosed the transaction as a non-adjusting event after the reporting period.

Answer

A financial liability for the present value of the maximum amount payable to shareholders should be recognised in the financial statements as of 31 August 2016. At 31 August 2016, the rights are equivalent *to a written put option because they represent for Evolve a purchase obligation which gives shareholders the right to sell the entity's own equity instruments for a fixed price.*

The fundamental principle of LKAS 32 Financial Instruments: Presentation is that a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form, and the definitions of financial liability and equity instrument. LKAS 32 states that a contract which contains an entity's obligation to purchase its own equity instruments gives rise to a financial liability, which should be recognised at the present value of its redemption amount. LKAS 32 also states that a contractual obligation for an entity to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation is conditional on the counterparty exercising a right to redeem, as is the case with the scrip issue of Evolve.

Evolve had set up the conditions for the share capital increase in August 2016 and, therefore, the contract gave rise to financial liabilities from that date and Evolve should have recognised a financial liability for the present value of the maximum amount payable to shareholders in its financial statements for the year ended 31 August 2016. A non-adjusting event under LKAS 10 Events after the Reporting Period is an event after the reporting period which is indicative of a condition which arose after the end of the reporting period. However, it could be argued that the transferring of the free allocation rights back to Evolve is in fact an adjusting event as it is an event after the reporting period which provides further evidence of conditions which existed at the end of the reporting period.

16.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

On 1 April 2015, Diamond acquired \$50 million of 6% listed bonds at their nominal value. Diamond may sell or hold bonds to maturity and so, based on this business model, has designated the bonds as fair value through other comprehensive income. The effective rate of interest on the bonds is also 6%. The bonds had a fair value of \$42 million at 31 March 2016 and were correctly treated in the financial statements of that year.

On 31 March 2017, Diamond received the coupon interest of \$3 million, which was recorded within interest received, and then sold the bonds on the same day for \$35 million. The disposal proceeds were substantially below the fair value of the bonds which was \$38 million at 31 March 2017. A \$7 million loss on disposal was charged against profits. Diamond has an option to repurchase the bonds at any time up to 31 December 2018 for \$36 million. The fair value is expected to increase in the future and it is highly likely that Diamond will exercise this option

Answer

The substance of the transaction appears to be that of a secured loan rather than a disposal of bonds. This is evidenced by the sale being below fair value and the fact that the repurchase price is also below expected fair value, such that the option is highly likely to be exercised. The proceeds of \$35 million should therefore be treated as a current liability (it is repayable at any time) rather than as a disposal of the bonds.

At 31 March 2016, prior to the loss, the bonds had a carrying amount of \$42 million. Interest received and taken to profit or loss (and retained earnings) is \$3 million (6% x \$50m). The carrying amount of the *bonds should be restated to fair value of $38 million at 31 March 2017. A loss of $4 million should be recorded in other components of equity calculated as follows:*

	$m
Balance at 31 March 2016	*42*
Interest income at effective rate of 6%	*3*
Less coupon rate of 6%	*(3)*
Loss to other components of equity	*(4)*
Balance at 31 March 2017	*38*

The following correcting entry is required to the financial statements of Diamond:

	Dr	*Cr*
Other financial assets	*38*	
Other components of equity	*4*	
Loss on disposal (retained earnings)		*7*
Current liabilities		*35*

17.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

Diamond is looking at ways that it may improve its liquidity. One option is to sell some of its trade receivables to a debt factor. The directors are considering two possible alternative agreements as described below:

1. Diamond could sell $40 million receivables to a factor with the factor advancing 80% of the funds in full and final settlement. The factoring is non-recourse except that Diamond has guaranteed that it will pay the factor a further 9% of each receivable which is not recovered within six months. Diamond believes that its customers represent a low credit risk and so the probability of default is very low. The fair value of the guarantee is estimated to be $50,000.

2. Alternatively, the factor would advance 20% of the $40 million receivables sold. Further amounts will become payable to Diamond but are subject to an imputed interest charge so that Diamond receives progressively less of the remaining balance the longer it takes the factor to recover the funds. The factor has full recourse to Diamond for a six-month period after which Diamond has no further obligations and has no rights to receive any further payments from the factor.

Required:

If Diamond decides to go ahead with the debt factoring arrangements, explain the financial reporting principles involved and advise how each of the above arrangements would impact upon the financial statements of future years.

Answer

SLFRS 9 Financial Instruments requires Diamond to consider the commercial substance rather than the legal form of the debt factoring arrangements. SLFRS 9 suggests that the trade receivables should be derecognised from the financial statements of Diamond when the following conditions are met:

- *(i) When Diamond has no further rights to receive cash from the factor.*
- *(ii) When the risks and rewards of ownership relating to the receivables have substantially been transferred to the factor.*
- *(iii) When Diamond has no further control over the trade receivables.*

With agreement one there is a sharing of the risks and rewards of ownership as the factoring is non-recourse except that Diamond retains an obligation to refund the factor 9% of irrecoverable debts. It can be seen, however, that substantially all the risks and rewards of ownership have passed to the factor. The probability of an individual default is low given that there is low credit risk and the factor would suffer the vast majority of the loss arising from any default. Diamond also has no further access to the rewards of ownership as the initial $32 million (80% x $40 million) is in full and final settlement. Furthermore, the factor has assumed full control over the collectability of the receivables. The trade receivables should be derecognized from the financial statements of Diamond and $8 million, being the difference between the value of the receivables sold and the cash received, should be charged as an irrecoverable debt expense against the profits of Diamond.

The guarantee should be treated as a separate financial liability in accordance with SLFRS 9. This would initially be measured at its fair value of $50,000.

Risks and rewards of ownership do not initially pass to the factor in relation to agreement two. The factor has full recourse to Diamond for a six-month period so the irrecoverable debt risk is still with Diamond. Furthermore, Diamond still has the right to receive further cash payments from the factor, the amounts to be received being dependent on when and if the customers pay the factor. Diamond therefore still has the risks associated with slow payment by their customers. The receivables must not initially be derecognised from their financial statements with the $8 million (20% x $40m) proceeds being treated as a short-term liability from the factor. The receivables and liability balances would gradually be reduced as the factor recovered the cash from Diamond's customers which would be adjusted for the imputed interest and expensed in profit or loss. Should there be any indication of impairment during the six-month period, the receivables should be credited with a corresponding charge to profit or loss.

Following six months the risks and rewards of ownership have passed to the factor and the balances on the loan and the receivables would be offset. The remaining balance following offset within the receivables of Diamond should be expensed in profit or loss as an irrecoverable debt.

18.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

On 1 March 2016, Carsoon invested in a debt instrument with a fair value of \$6 million and has assessed that the financial asset is aligned with the fair value through other comprehensive income business model. The instrument has an interest rate of 4% over a period of six years. The effective interest rate is also 4%. On 1 March 2016, the debt instrument is not impaired in any way. During the year to 28 February 2017, there was a change in interest rates and the fair value of the instrument seemed to be affected. The instrument was quoted in an active market at \$5·3 million but the price based upon an in-house model showed that the fair value of the instrument was \$5·5 million. This valuation was based upon the average change in value of a range of instruments across a number of jurisdictions.

The directors of Carsoon felt that the instrument should be valued at \$5·5 million and that this should be shown as a Level 1 measurement under SLFRS 13 Fair Value Measurement. There has not been a significant increase in credit risk since 1 March 2016, and expected credit losses should be measured at an amount equal to 12-month expected credit losses of \$400,000. Carsoon sold the debt instrument on 1 March 2017 for \$5·3 million. The directors of Carsoon wish to know how to account for the debt instrument until its sale on 1 March 2017. (8 marks)

Answer

For financial assets which are debt instruments measured at fair value through other comprehensive income (FVOCI), both amortised cost and fair value information are relevant because debt instruments in this measurement category are held for both the collection of contractual cash flows and the realisation of fair values. Therefore, debt instruments measured at FVOCI are measured at fair value in the statement of financial position. In profit or loss, interest revenue is calculated using the effective interest rate method and impairment gains and losses are derived using the same method as for financial assets measured at amortised cost. The fair value gains and losses on these financial assets are recognised in other comprehensive income (OCI). As a result, the difference between the total change in fair value and the amounts recognised in profit or loss are shown in OCI. When these financial assets are derecognised, the cumulative gains and losses previously recognised in OCI are reclassified from equity to profit or loss. Expected credit losses (ECLs) do not reduce the carrying amount of the financial assets, which remains at fair value. Instead, an amount equal to the ECL allowance which would arise if the asset were measured at amortised cost is recognised in OCI.

The fair value of the debt instrument therefore needs to be ascertained at 28 February 2017. SLFRS 13 Fair Value Measurement states that Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities which the entity can access at the measurement date. The standard sets out that adjustment to Level 1 prices should not be made except in certain circumstances. An entity may, as a practical expedient, measure fair value using an alternative pricing method which does not rely exclusively on quoted prices and this price would be within a lower level of the fair value hierarchy. In-house models are alternative pricing methods which do not rely exclusively on quoted prices. It would seem that a Level 1 input is available, based upon activity in the market and further that, because of the active market, there is no reason to use a 'practical expedient' to value the debt.

Therefore the accounting for the instrument should be as follows: The bonds will be initially recorded at \$6 million and interest of \$0·24 million will be received and credited to profit or loss. At 28 February

2017, the bonds will be valued at $5·3 million, which recognises 12-month credit losses and other reductions in fair value. The loss of $0·7 million will be charged as an impairment loss of $0·4 million to profit or loss and $0·3 million to OCI. When the bond is sold for $5·3 million on 1 March 2017, the financial asset is derecognised and the loss in OCI ($0·3 million) is reclassified to profit or loss. Also the fact that the bond is sold for $5·3 million on 1 March 2017 illustrates that this should have been the fair value on 28 February 2017.

19.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

Skye has B shares in issue which allow the holders to request redemption at specified dates and amounts. The legal charter of Skye states that the entity has a choice whether or not to accept the request for repayment of the B shares. There are no other conditions attached to the shares and Skye has never refused to redeem any of the shares up to the current year end of 31 May 2017. In all other respects the instruments have the characteristics of equity.

Skye also has preference shares in issue which are puttable by the holders at any time after 31 May 2017. Under the terms of the shares, Skye has to satisfy the obligation for the preference shares only if it has sufficient distributable reserves. Local legislation is quite restrictive in defining the profits available for distribution as dividends.

The directors of Skye wish advice on how to account for the above financial instruments in the company's financial statements at 31 May 2017. (5 marks)

Answer

LKAS 32 Financial Instruments: Presentation states that a liability is a contractual obligation to deliver cash or another financial asset to another entity and that equity is any contract which evidences a residual interest in the assets of an entity after deducting all of its liabilities. In this case, Skye has no obligation to transfer cash or another asset to the holders of the instruments and therefore the B shares should be classed as equity. The fact that Skye has not refused redemption in the past does not cause the B shares to be classified as a liability.

The preference shares create an obligation for Skye because of the put option clause in the agreement. The fact that Skye may not be in a position to satisfy the put option feature because of insufficient distributable reserves does not negate the fact that Skye has an obligation.

20.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

On 30 November 2017, Formatt loaned $8 million to a third party at an agreed interest rate. At the same time, it sold the third party loan to Window whereby, in exchange for an immediate cash payment of $7 million, Formatt agreed to pay to Window the first $7 million plus interest collected from the third party loan. Formatt retained the right to $1 million plus interest. The 12-month expected credit losses are $300,000 and Formatt has agreed to suffer all credit losses. A receivable of $1m has been recognised in the financial statements at 30 November 2017.

As a result of the agreement with Window, the directors of Formatt are unsure as to whether they should recognize any part of the interest bearing loan of $8 million in the statement of financial position at 30

November 2017. They understand that the Conceptual Framework and the Exposure Draft: Conceptual Framework for Financial Reporting both mention 'control' as one of the criteria for recognition of an asset but do not understand the interaction between the Conceptual Framework and SLFRS 9 Financial Instruments as regards the recognition of a financial asset. (8 marks)

Required:

Advise the directors of Formatt on how the above elements should be dealt with in its financial statements with reference to relevant SLFRSs and, where necessary, pronouncements on the Conceptual Framework

Answer

The Conceptual Framework defines an asset as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. The existing Conceptual Framework does not define control. The Exposure Draft: Conceptual Framework for Financial Reporting defines an asset as a present economic resource controlled by the entity as a result of past events. It goes on to say that control links the economic resource to the entity and that assessing control helps to identify what economic resource the entity should account for. For example, if an entity has a proportionate share in a property without controlling the entire property, the entity's asset is its share in the property, which it controls, not the property itself, which it does not. An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits which flow from it. However, risks and rewards can be a helpful factor to consider when determining the transfer of control.

The entity should consider whether the contractual rights to the cash flows from the asset have expired as, if so, the asset should be derecognised. Second, if the contractual rights to the cash flows have not expired, as is the case with Formatt, the entity should consider whether it has transferred the financial asset. When an entity transfers a financial asset, it should evaluate the extent to which it retains the risks and rewards. SLFRS 9 Financial Instruments provides three examples of when an entity has transferred substantially all the risks and rewards of ownership. These are an unconditional sale of a financial asset, sale of a financial asset with an option to repurchase the financial asset at its fair value and sale of a financial asset which is deeply 'out of the money'. Thus in this case, even though most of the cash flows which are derived from the loan are passed on to Window (up to a maximum of $7 million), Formatt is essentially still in 'control' of the asset as the risks and rewards have not been transferred because of the subordinated retained interest. Formatt's residual interest also absorbs the potential credit losses.

If Formatt has neither retained nor transferred substantially all of the risks and rewards of ownership, the assessment of control is important. If control has been retained, the entity would continue to recognise the asset to the extent of its continuing involvement.

However, as Formatt has retained the risks and rewards, it should recognise the financial asset in the statement of financial position and the 12-month expected credit losses.

21.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

On 1 September 2016, Darlatt entered into a fixed price forward contract to purchase 2,000 tonnes of steel at 400 euros (€) per tonne. The local currency is the dollar ($). This purchase is in accordance with its normal usage requirements.

The contract allows Darlatt to take delivery of the steel on 31 August 2018 or to pay or receive net settlement in cash, based upon the change in the value of steel but not on the change in the foreign currency exchange rate. Darlatt has not settled similar contracts in the past before delivery of the steel. Darlatt does not have a foreign currency contract to hedge against any risk caused by any movement in the dollar/euro exchange rate and has paid a non-refundable deposit of €100,000 at 1 September 2016. The following exchange rates are relevant:

Date	Exchange rate (euros:dollars)
1 September 2016	2:1
31 August 2017	1·75:1

There had been no change in the contract price of steel at 31 August 2017 and it is felt that the decline in the dollar/euro exchange rate is unlikely to be reversed.

The directors of Darlatt would like to know how to account for the above contract at 31 August 2017 and whether it is within the scope of SLFRS 9 Financial Instruments, together with any implications of the change in the dollar/euro exchange rate. (7 marks)

Answer

The contract is not accounted for under SLFRS 9 Financial Instruments. The contract is simply a right and an obligation to exchange economic resources (or to pay or receive the difference in values between two economic resources if the contract will be settled net).The entity should therefore apply the general measurement concepts in the Conceptual Framework and the relevant SLFRS.

The result in this case would be that the contract would be measured at zero and hence is not recognised unless the contract is onerous.

If an entity enters into a forward contract to purchase a resource at a future date, the entity's asset is normally its right to buy the underlying resource, not the underlying resource itself. However, there may be circumstances in which the terms of a forward contract to purchase a resource give the purchaser control of that resource. In such circumstances, the purchaser should identify both an asset (the underlying resource which it already controls) and a liability (its obligation to pay for the resource).

In practice, obligations under contracts which are not performed would not be accrued in the financial statements. For example, the liability for the steel ordered but not yet received would not generally be *recognised as a liability in the financial statements. If historical cost measurement is applied to the contract, the contract would be measured at zero which has the same practical effect as not recognising the contract unless it is onerous. However, in order to achieve consistency with the existing requirements in LKAS 2 Inventories, a contract would be regarded as onerous if the contractual price payable for the inventory exceeded its net realisable value. At 31 August 2017, the price which Dalatt would have to pay for the steel would be (2,000 tonnes x €400/1·75), i.e. $457,142. At the time of the contract, the contract price would have been (2,000 tonnes x €400/2), i.e. $400,000. Therefore it can be argued that a provision of $57,142 should be made as the fall in the dollar/euro exchange is unlikely to be reversed.*

The deposit paid of €100,000 is a non-monetary item as it is non-refundable. LKAS 21 The Effects of Changes in Foreign Exchange Rates states that the essential feature of a non-monetary item is the absence of a right to receive or an obligation to deliver a fixed or determinable number of units of currency. The standard further gives an example of non-monetary items as amounts prepaid for goods and services. Non-monetary items which are measured in terms of historical cost or fair value are translated using the exchange rate at the date of the transaction or at the date when the fair value was measured. Thus the deposit will be stated at $50,000 in the financial statements under current assets.

22.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

Discuss the importance of the classification of equity and liabilities under International Financial Reporting Standards and how this classification has an impact on the information disclosed to users in the statement of profit or loss and other comprehensive income and the statement of financial position.

Answer

Whether an instrument is classified as either a financial liability or as equity is important as it has a direct effect on an entity's reported results and financial position. The critical feature of a liability is that, under the terms of the instrument, the issuer is or can be required to deliver either cash or another financial asset to the holder and it cannot avoid this obligation. An instrument is classified as equity when it represents a residual interest in the issuer's assets after deducting all its liabilities. If the financial instrument provides the entity an unconditional discretion, the financial instrument is equity.

LKAS 32 Financial Instruments Presentation sets out the nature of the classification process but the standard is principle based and sometimes the outcomes are surprising to users. LKAS 32 focuses on the contractual obligations of the instrument and considers the substance of the contractual rights and obligations. The variety of instruments issued by entities makes this classification difficult with the application of the principles occasionally resulting in instruments which seem like equity being accounted for as liabilities. Recent developments in the types of financial instruments issued have added more complexity to capital structures with the resultant difficulties in interpretation and understanding.

Equity and liabilities are classified separately in the statement of financial position. The Conceptual Framework distinguishes the two elements by the obligation of the entity to deliver cash or other economic resources from items which create no such obligation. The statement of profit or loss and other comprehensive income (OCI) includes income and expenses arising from liabilities which is interest and, if applicable, remeasurement and gain or loss on settlement. The statement does not report as income or expense any changes in the carrying amount of the entity's own equity instruments but does include *expenses arising from the consumption of services which fall under SLFRS 2 Share-based Payment. SLFRS 2 requires a valuation of the services consumed in exchange for the financial liabilities or equity instruments.In the statement of financial position, the carrying amount of many financial liabilities changes either with the passage of time or if the liability is remeasured at fair value. However, the amount reported for classes of equity instruments generally does not change after initial recognition except for non-controlling interest.*

Liability classification typically results in any payments on the instrument being treated as interest and charged to earnings. This may in turn affect the entity's ability to pay dividends on its equity shares depending upon local legislation.

Equity classification avoids the negative impact which liability classification has on reported earnings, gearing ratios and debt covenants. It also results in the instrument falling outside the scope of SLFRS 9 Financial Instruments, thereby avoiding the complicated ongoing measurement requirements of that standard.

23.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

Amster has issued two classes of preference shares. The first class was issued at a fair value of $50 million on 30 November 2017. These shares give the holder the right to a fixed cumulative cash dividend of 8% per annum of the issue price of each preferred share. The company may pay all, part or none of the dividend in respect of each preference share. If the company does not pay the dividend after six months from the due date, then the unpaid amount carries interest at twice the prescribed rate subject to approval of the management committee. The preference shares can be redeemed but only on the approval of the management committee.

The second class of preference shares was issued at a fair value of $25 million and is a non-redeemable preference share. The share has a discretionary annual dividend which is capped at a maximum amount. If the dividend is not paid, then no dividend is payable to the ordinary shareholders. Amster is currently showing both classes of preference shares as liabilities.

On 1 December 2016, Amster granted 250 cash-settled share awards to each of its 1,500 employees on the condition that the employees remain in its employment for the next three years. Cash is payable at the end of three years based on the share price of the entity's shares on that date. During the year to 30 November 2017, 65 employees left and, at that date, Amster estimates that an additional 115 employees will leave during the following two years. The share price at 30 November 2017 is $35 per share and it is anticipated that it will rise to $46 per share by 30 November 2019. Amster has charged the expense to profit or loss and credited equity with the same amount.

The capitalisation table of Amster is set out below:

Amster Group – capitalisation table

	30 November 2017 ($ million)
Long-term liabilities	81
Pension plan deficit	30
Cumulative preference shares	75
Total long-term liabilities	186
Non-controlling interest	10
Shareholders equity	150
Total group equity	160
Total capitalisation	346

Required:

Discuss whether the accounting treatment of the above transactions is acceptable under International Financial Reporting Standards including any adjustment which is required to the capitalisation table and the effect on the gearing and the return on capital employed ratios. (9 marks)

Answer

In the case of the first class of preference shares, even though there are negative consequences of not paying dividends on the preferred shares as agreed contractually, the company can avoid the obligation to deliver cash. The preferred shares do have redemption provisions but these are not mandatory and are at the sole discretion of the management committee and therefore the shares should be classified as equity.

In the case of the second class, the contractual term requires no dividend to be paid to ordinary shareholders if a payment is not made on the preferred shares. In this case, as Amster can avoid the obligation to settle the annual dividend, the shares are classified as equity. Thus $75 million should be transferred from liabilities to equity.

SLFRS 2 Share-based Payment states that cash settled share-based payment transactions occur where goods or services are paid for at amounts which are based on the price of the company's equity instruments. The expense for cash settled transactions is the cash paid by the company and any amounts accrued should be shown as liabilities and not equity. Therefore Amster should remove the following amount from equity and show it as a liability.

Expense for year to 30 November 2017 is:

((1,500 – 180 employees x 250 awards x $35) x 1/3 = $3·85 million

As a result of the adjustments to the financial statements, Amster's gearing ratio will be lowered significantly as the liabilities will drop from 53·8% of total capitalisation to 33·2% of total capitalisation. However, the ROCE may stay the same even though there is an increase in shareholders equity as total capitalisation has not changed. However, this will depend upon the definition used by the entity for capital employed.

Amster Group – capitalisation table

	30 November 2017 ($ million)	Adjustment ($m)	30 November 2017 ($ million)
Long-term liabilities	81	3·85	84·85
Pension plan deficit	30		30
Cumulative preference shares	75	(75)	–
Liabilities	186		114·85
Non-controlling interest	10		10
Shareholders equity	150	(75 – 3·85)	221·15
Group equity	160		231·15
Total capitalisation	346		346

24.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments

Spamgate is a financial institution which acts in the retail sector providing loans and mortgages to companies and individuals. This is its core business model and it seldom buys or sells financial assets. In January 2017, it provided a loan to Bosey, a public limited company, however, shortly after obtaining the loan, Bosey reported significant operating losses during the financial year ended 31 May 2017. Bosey has made unsuccessful attempts to attract new investors by offering them a low preference share subscription price. The poor liquidity position of Bosey has forced Spamgate to accept these preference shares in exchange for part of the loan. The preference share price used to calculate the exchange rate for the loans was three times higher than the subscription price for the unsuccessful share issue. Spamgate accounted for the exchange of its loan investments for preference shares in Bosey by reducing the carrying amount of the loans, and increasing the value of the investment in Bosey's shares. Spamgate intends to sell the preference shares held in Bosey as soon as it is feasible but does not consider this transaction to have changed its core business model.

In the year ended 31 May 2018, Spamgate has measured the loan to Bosey at amortised cost and the preference shares held in Bosey at fair value through other comprehensive income (FVOCI). The directors of Spamgate would like advice on the measurement of the loan and preference shares held in Bosey and the accounting treatment of the share exchange in the year ended 31 May 2018.

Answer

The measurement of financial instruments is dependent on the business model of the entity. The business model of an entity can typically be observed through the activities which an entity undertakes to achieve its business objective. The business model is a matter of fact rather than an assertion. The assessment of a business model is based on how key personnel actually manage the business, rather than management's intent for specific financial assets. It implies a more rigorous test and may potentially require entities to provide additional evidence or accumulate more historical analysis. SLFRS 9 Financial Instruments has taken a strategic approach as the business model test requires companies to assess the nature of their business and how it allocates its financial assets. It is not as simple as establishing the nature and risk of the asset itself.

Financial assets are held at amortised cost where the entity has a business model whose objective is to hold assets to collect contractual cash flows. Having some sales activity is not necessarily inconsistent with this business model. For example, sales which are infrequent or insignificant in value or have been made as a result of an increase in credit risk may be consistent with this business model.

Financial assets classified and measured at fair value through other comprehensive income are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. Compared to a business model whose objective is to hold financial assets to collect contractual cash flows, this business model will typically involve greater frequency and volume of sales. This measurement category results in amortised cost information being provided in profit or loss and fair value information in the statement of financial position.

It appears that Spamgate has a business model whose objective is to hold assets in order to collect contractual cash flows as it seldom buys and sells financial assets but issues loans to individuals and businesses. It has only accepted the preference shares in Bosey because of the poor liquidity position of Bosey. Although Spamgate intends to sell the preference shares held in Bosey as soon as it is feasible, it does not intend to change its business model. Therefore, both the loans and the shares in Bosey should be valued at amortised cost.

The exchange of part of the loan for Bosey's shares should lead to the derecognition of that part of the loan as Spamgate's rights to that part of the loan have expired and the risks and rewards relating to that part of the loan have been extinguished.

Upon derecognition, the difference between the carrying amount of the loans and the fair value of the preference shares received should have been presented as a loss on loans instead of reducing the carrying amount of the loans, with an offsetting increase in the value of the investment in Bosey's shares. In addition, the valuation of the preference shares was not based upon their fair value as the share price used to calculate the exchange rate for the loans was three times higher than the subscription price for the unsuccessful share issue. This seems to indicate that the fair value of the shares received in the conversion was considerably lower than that used to reduce the carrying amount of the converted loans.

In addition, Spamgate is required, under SLFRS 9, to recognise expected credit losses and to update the amount of expected credit losses recognised at each reporting date to reflect changes in the credit risk of financial instruments. This does not appear to have occurred.

For financial assets carried at amortised cost, a gain or loss is recognised when the financial asset is derecognised. Upon derecognition, the difference between the loans' carrying amount and the fair value of the shares received should have been recognised as a gain or loss.

25.) Question - SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments & LKAS 12 Income tax

Background

Stent Co is a consumer electronics company which has faced a challenging year due to increased competition. Stent Co has a year end of 30 September 20X9 and the unaudited draft financial statements report an operating loss. In addition to this, debt covenant limits based on gearing are close to being breached and the company is approaching its overdraft limit.

Cash advance from Budster Co

On 27 September 20X9, Stent Co's finance director asked the accountant to record a cash advance of $3m received from a customer, Budster Co, as a reduction in trade receivables. Budster Co is solely owned by Stent Co's finance director. The accountant has seen an agreement signed by both companies stating that the $3m will be repaid to Budster Co in four months' time. The finance director argues that the proposed accounting treatment is acceptable because the payment has been made in advance in case Budster Co wishes to order goods in the next four months.

However, the accountant has seen no evidence of any intent from Budster Co to place orders with Stent Co. (4 marks)

Preference shares

On 1 October 20X8, the CEO and finance director each paid $2m cash in exchange for preference shares from Stent Co which provide cumulative dividends of 7% per annum. These preference shares can either be converted into a fixed number of ordinary shares in two years' time, or redeemed at par on the same date, at the choice of the holder.

The finance director suggests to the accountant that the preference shares should be classified as equity because the conversion is into a fixed number of ordinary shares on a fixed date ('fixed for fixed') and conversion is certain (given the current market value of the ordinary shares). (4 marks)

Deferred tax asset

Stent Co includes a deferred tax asset in its statement of financial position, based on losses incurred in the current and the previous two years. The finance director has asked the accountant to include the deferred tax asset in full. He has suggested this on the basis that Stent Co will return to profitability once its funding issues are resolved. (3 marks)

Required:

(a) Discuss appropriate accounting treatments which Stent Co should adopt for all issues identified above and their impact upon gearing.

Answer

Cash advance from Budster Co

Stent Co's finance director also controls Budster Co, the company which has paid a cash advance to Stent Co. International Accounting Standard (IAS®) 24 Related Party Disclosures requires an entity's financial statements to contain disclosures necessary to draw attention to the possibility that its financial statements may have been affected by the existence of related parties and by transactions and outstanding balances with such parties. Included in the definition of a related party is a person identified as holding significant influence over the entity, or who is a member of the key management personnel of the entity. The finance director, a key management personnel of Stent Co, is a related party. In this case, Stent Co must disclose the nature of the related party relationship as well as information about all transactions and outstanding balances between Stent Co and Budster Co (owned and controlled by the finance director), necessary for users to understand the potential effect of the relationship on the financial statements.

The advance from Budster Co meets the Conceptual Framework definition of a liability: Stent Co has a present obligation (legally enforceable as a consequence of a binding contract), the settlement of which involves Stent Co giving up resources embodying economic benefits in order to satisfy the claim. IAS 1 Presentation of Financial Statements states that an entity shall not offset assets and liabilities, unless required or permitted by an International Financial Reporting Standard (IFRS®). The finance director wants to include the receipt as a credit balance in trade receivables, netting off any amounts owed by Budster Co from trading, with what appears to be a short-term loan. This would result in a misclassification of a current liability under current assets. Offsetting a financial asset and a financial liability is permitted according to IAS 32 Financial Instruments: Presentation when, and only when, an entity has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. No such agreement is evident in this case, so Stent Co should report separately both assets and liabilities.

Except when it reflects the substance of the transaction or other event, offsetting detracts from the ability of users both to understand the transactions, other events and conditions which have occurred and to assess the entity's future cash flows. Stent Co would be showing a lower current asset figure and concealing the liability, which if disclosed as a current liability could be included in the debt element of the gearing calculation. Gearing would therefore increase.

Convertible redeemable preference shares

IAS 32 defines an equity instrument as any contract which evidences a residual interest in the assets of an entity after deducting all of its liabilities. An equity instrument has no contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities under potentially unfavourable conditions. If settled by the issuer's own equity instruments, an equity instrument has no *contractual obligation to deliver a variable number, or is settled only by exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.*

Preference shares which are required to be converted into a fixed number of ordinary shares on a fixed date should be classified as equity (this is known as the 'fixed for fixed' requirement to which the finance director refers). However, a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer either to deliver cash or another financial asset to the holder, or to exchange financial assets or financial liabilities with the holder, under conditions which are potentially unfavourable to the issuer. In this case, Stent Co has issued convertible redeemable preference shares – which makes little commercial sense from the company's perspective, as they offer the holder the benefit of conversion into ordinary shares if share prices rise, and the security of redemption (at the choice of the holder) if share prices fall.

IAS 32 notes that the substance of a financial instrument, rather than its legal form, governs its classification in the entity's statement of financial position. A preference share which provides for mandatory redemption for a fixed or determinable amount at a fixed or determinable future date or gives the holder the right to require the issuer to redeem the instrument at a particular date for a fixed or determinable amount is a financial liability.

Because the preference shares offer the holder the choice of conversion into ordinary shares as well as redemption in two years' time, the terms of the financial instrument should be evaluated to determine whether it contains both a liability and an equity component. Such components are classified separately as compound financial instruments, recognising separately the components of a financial instrument which creates both a financial liability of the entity (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity).

In accordance with IFRS 9 Financial Instruments, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. Stent Co would measure the fair value of the consideration in respect of the liability component based on the fair value of a similar liability without any associated equity conversion option. The equity component is assigned the residual amount.

Gearing would increase if the draft financial statements had included the preference shares within equity: the correction would increase non-current debt (the present value of the future obligations) and decrease equity.

Deferred tax asset

In accordance with IAS 12 Income Taxes, a deferred tax asset shall be recognised for the carry-forward of unused tax losses to the extent that it is probable that future taxable profit will be available against which the unused tax losses can be utilised. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses only to the extent that it has convincing evidence that sufficient taxable profit will be available against which the unused tax *losses can be utilised. In such circumstances, the amount of the deferred tax asset and the nature of the evidence supporting its recognition must be disclosed.*

The directors of Stent Co should consider whether it is probable that Stent Co will have taxable profits before the unused tax losses or unused tax credits expire, whether the unused tax losses result from identifiable causes which are unlikely to recur; and whether tax planning opportunities are available to the entity which will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised. To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset should not be recognised.

The removal of a deferred tax asset would reduce net assets, and equity. Gearing would therefore increase.

26.) Question - LKAS 37 Provisions, Contingent Liabilities and Contingent Assets / SLFRS 3 Business Combinations

William acquired another entity, Chrissy, on 1 May 2012. At the time of the acquisition, Chrissy was being sued as there is an alleged mis-selling case potentially implicating the entity. The claimants are suing for damages of Rs.10 million. William estimates that the fair value of any contingent liability is Rs.4 million and feels that it is more likely than not that no outflow of funds will occur.

William wishes to know how to account for this potential liability in Chrissy's entity financial statements and whether the treatment would be the same in the consolidated financial statements (5 marks)

<u>Answer</u>

LKAS 37 Provisions, Contingent Liabilities and Contingent Assets describes contingent liabilities in two ways. Firstly, a possible obligations whose existence will be confirmed only on the occurrence or non-occurrence of uncertain future events outside the entity's control, or secondly, as present obligations that are not recognised because: (a) it is not probable that an outflow of economic benefits will be required to settle the obligation; or (b) the amount cannot be measured reliably.

In Chrissy's financial statements contingent liabilities are not recognised but are disclosed and described in the notes to the financial statements, including an estimate of their potential financial effect and uncertainties relating to the amount or timing of any outflow, unless the possibility of settlement is remote.

However, in a business combination, a contingent liability is recognised if it meets the definition of a liability and if it can be measured. The first type of contingent liability above under LKAS 37 is not recognised in a business combination. However, the second type of contingency is recognised whether or not it is probable that an outflow of economic benefits takes place but only if it can be measured reliably.

This means William would recognise a liability of Rs.4 million in the consolidated accounts. Contingent liabilities are an exception to the recognition principle because of the reliable measurement criteria.

27.) Question - SLFRS 3 Business Combinations

Kayte operates in the shipping industry and owns vessels for transportation. In June 2014, Kayte acquired Ceemone whose assets were entirely investments in small companies. The small companies each owned and operated one or two shipping vessels. There were no employees in Ceemone or the small companies. At the acquisition date, there were only limited activities related to managing the small companies as most activities were outsourced. All the personnel in Ceemone were employed by a separate management company. The companies owning the vessels had an agreement with the management company concerning assistance with chartering, purchase and sale of vessels and any technical management. The management company used a shipbroker to assist with some of these tasks.

Kayte accounted for the investment in Ceemone as an asset acquisition. The consideration paid and related transaction costs were recognised as the acquisition price of the vessels. Kayte argued that the vessels were only passive investments and that Ceemone did not own a business consisting of processes, since all activities regarding commercial and technical management were outsourced to the management company. As a result, the acquisition was accounted for as if the vessels were acquired on a stand-alone basis.

Additionally, Kayte had borrowed heavily to purchase some vessels and was struggling to meet its debt obligations. Kayte had sold some of these vessels but in some cases, the bank did not wish Kayte to sell the vessel. In these cases, the vessel was transferred to a new entity, in which the bank retained a variable interest based upon the level of the indebtedness. Kayte's directors felt that the entity was a subsidiary of the bank and are uncertain as to whether they have complied with the requirements of SLFRS 3 Business Combinations and SLFRS 10 Consolidated Financial Statements as regards the above transactions.

Required:

Discuss the accounting treatment of the above transactions in the financial statements of Kayte. (12 marks)

Answer

The accounting for the transaction as an asset acquisition does not comply with the requirements of SLFRS 3 Business Combinations and should have been accounted as a business combination. This would mean that transaction costs would be expensed, the vessels recognised at fair value, any deferred tax recognised at nominal value and the difference between these amounts and the consideration paid to be recognised as goodwill.

In accordance with SLFRS 3, an entity should determine whether a transaction is a business combination by applying the definition of a business in SLFRS 3. A business is an integrated set of activities and assets which is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants. A business consists of inputs and processes applied to those inputs which have the ability to *create outputs. Although businesses usually have outputs, outputs are not required to qualify as a business.*

When analysing the transaction, the following elements are relevant:

(i) Inputs: Shares in vessel owning companies, charter arrangements, outsourcing arrangements with a management company, and relationships with a shipping broker.

(ii) Processes: Activities regarding chartering and operating the vessels, financing the business, purchase and sales of vessels.

(iii) Outputs: Ceemone would generate revenue from charter agreements and has the ability to gain economic benefit from the vessels.

SLFRS 3 states that whether a seller operated a set of assets and activities as a business or intends to operate it as a business is not relevant in evaluating whether it is a business. It is not relevant therefore that some activities were outsourced as Ceemone could chose to conduct and manage the integrated set of assets and activities as a business. As a result, the acquisition included all the elements which constitute a business, in accordance with SLFRS 3.

SLFRS 10 Consolidated Financial Statements sets out the situation where an investor controls an investee. This is the case, if and only if, the investor has all of the following elements:

(i) power over the investee, that is, the investor has existing rights which give it the ability to direct the relevant activities (the activities which significantly affect the investee's returns);

(ii) exposure, or rights, to variable returns from its involvement with the investee;

(iii) the ability to use its power over the investee to affect the amount of the investor's returns.

Where a party has all three elements, then it is a parent; where at least one element is missing, then it is not. In every case, SLFRS 10 looks to the substance of the arrangement and not just to its legal form. Each situation needs to be assessed individually. The question arises in this case as to whether the entities created are subsidiaries of the bank. The bank is likely to have power over the investee, may be exposed to variable returns and certainly may have the power to affect the amount of the returns. Thus the bank is likely to have a measure of control but the extent will depend on the constitution of the entity.

28.) Question - SLFRS 3 Business Combinations / LKAS 40 Investment Property

Evolve operates in a jurisdiction with a specific tax regime for listed real estate companies. Upon adoption of this tax regime, the entity has to pay a single tax payment based on the unrealised gains of its investment properties. Evolve purchased Monk whose only asset was an investment property for $10 million. The purchase price of Monk was below the market value of the investment property, which was $14 million, and Evolve chose to account for the investment property under the cost model. However, Evolve considered that the transaction constituted a 'bargain purchase' under SLFRS 3 Business Combinations. As a result, Evolve accounted for the potential gain of $4 million in profit or loss and increased the 'cost' of the investment property to $14 million. At the same time, Evolve opted for the specific tax regime for the newly acquired investment property and agreed to pay the corresponding tax of

$1 million. Evolve considered that the tax payment qualifies as an expenditure necessary to bring the property to the condition necessary for its operations, and therefore was directly attributable to the acquisition of the property. Hence, the tax payment was capitalised and the value of the investment property was stated at $15 million. (6 marks)

Answer

SLFRS 3 Business Combinations must be applied when accounting for business combinations, but does not apply where the acquisition is not of a business. In this case, the acquisition was essentially that of an asset and therefore the measurement requirements of SLFRS 3 would not apply.

LKAS 40 Investment Property states that the cost of an investment property comprises its purchase price and any directly attributable expenditure, such as professional fees for legal services. LKAS 16 Property, Plant and Equipment states that the cost of an item of PPE comprises any cost directly attributable to bringing the asset to the condition necessary for it to be capable of operating in the manner intended by management. Hence if Evolve wishes to use the cost basis for accounting for the investment property, the potential gain should not have been recorded in profit or loss or added to the cost of the asset.

Evolve should have recognised the tax payment as an expense in the statement of profit or loss and other comprehensive income. Administrative and other general overhead costs are not costs of an item of PPE according to LKAS 16. The specific fiscal treatment and the tax to be paid were not linked to bringing the asset to the condition necessary for its operations, as the asset would have been operational without the tax. As such, the tax is a cost linked to the activity of Evolve and should be accounted for as an expense in accordance with LKAS 12 Income Taxes and included in the profit or loss for the period, unless that tax arises from a transaction recognised outside profit or loss.

29.) Question - SLFRS 3 Business Combinations

On 28 February 2017, Canto acquired all of the share capital of Binlory, a company which manufactures and supplies industrial vehicles. At the acquisition date, Binlory has an order backlog, which relates to a contract between itself and a customer for 10 industrial vehicles to be delivered in the next two years.

In addition, Binlory requires the extensive use of water in the manufacturing process and can take a pre-determined quantity of water from a water source for industrial use. Binlory cannot manufacture vehicles without the use of the water rights. Binlory was the first entity to use water from this source and acquired this legal right at no cost several years ago. Binlory has the right to continue to use the quantity of water for manufacturing purposes but any unused water cannot be sold separately. These rights can be lost over time if non-use of the water source is demonstrated or if the water has not been used for a certain number of years. Binlory feels that the valuation of these rights is quite subjective and difficult to achieve.

The directors of Canto wish to know how to account for the above intangible assets on the acquisition of Binlory. (7 marks)

Answer

SLFRS 3 Business Combinations states that an acquirer should recognise, separately from goodwill, the identifiable intangible assets acquired in a business combination. An asset is identifiable if it meets either *the separability or contractual-legal criteria in LKAS 38 Intangible Assets. Customer relationship intangible assets may be either contractual or non-contractual. Contractual customer relationships are normally recognised separately from goodwill as they meet the contractual-legal criterion. However, non-contractual customer relationships are recognised separately from goodwill only if they meet the separable criterion.*

Consequently, determining whether a relationship is contractual is critical to identifying and measuring both separately recognised customer relationship intangible assets and goodwill, and different conclusions could lead to substantially different accounting outcomes.

In the case of accounting for the acquisition of Binlory, the order backlog should be treated as an intangible asset on the acquisition. The fair value of the order backlog is estimated based on the expected revenue to be received, less the costs to deliver the product or service.

Canto has acquired water acquisition rights as part of a business combination.

The rights are valuable, as Binlory cannot manufacture vehicles without them. The rights were acquired at no cost and renewal is certain at little or no cost. The rights cannot be sold other than as part of the sale of a business as a whole, so there exists no secondary market in the rights. If Binlory does not use the water, then it will lose the rights. In this case, the legal rights cannot be measured separately from the business as a whole and therefore from goodwill. Binlory would not be able to manufacture without the rights. Therefore, the legal rights should not be accounted for as a separate intangible asset acquired in the business combination because the fair value cannot be measured reliably as the legal rights cannot be separated from goodwill.

30.) Question - LKAS 28 Investments in Associates and Joint Ventures

Greenie was one of three shareholders in a regional airport Manair. As at 30 November 2010, the majority shareholder held 60•1% of voting shares, the second shareholder held 20% of voting shares and Greenie held 19•9% of the voting shares.

The board of directors consisted of ten members. The majority shareholder was represented by six of the board members, while Greenie and the other shareholder were represented by two members each. A shareholders' agreement stated that certain board and shareholder resolutions required either unanimous or majority decision. There is no indication that the majority shareholder and the other shareholders act together in a common way. During the financial year, Greenie had provided Manair with maintenance and technical services and had sold the entity a software licence for $5 million. Additionally, Greenie had sent a team of management experts to give business advice to the board of Manair. Greenie did not account for its investment in Manair as an associate, because of a lack of significant influence over the entity.

Greenie felt that the majority owner of Manair used its influence as the parent to control and govern its subsidiary.

Discuss whether Greenie has significant influence over Manair. (5 marks)

Answer

Greenie appears to have significant influence over Manair, and therefore, it should be accounted for as an associate. According to paragraph 2 of LKAS 28 'Investments in Associates', significant influence is the power to participate in the financial and operating decisions of the investee but is not control or joint control over the policies. Where an investor holds 20% or more of the voting power of the investee, it is presumed that the investor has significant influence unless it can be clearly demonstrated that this is not the case. If the investor holds less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated (LKAS 28, paragraph 6).

In certain cases, whether significant influence exists should also be assessed when an investor holds less than 20% especially where it appears that the substance of the arrangement indicates significant influence. Greenie holds 19·9% of the voting shares and it appears as though there has been an attempt to avoid accounting for Manair as an associate. The fact that one investor holds a majority share of the voting power can indicate that other investors do not have significant influence. A substantial or majority ownership by an investor does not, however, necessarily preclude other investors from having significant influence (LKAS 28 paragraph 6). LKAS 28 paragraph 7 states that the existence of significant influence by an investor is usually evidenced in one or more of the following ways:

(i) representation on the board of directors or equivalent governing body of the investee;

(ii) participation in the policy-making process;

(iii) material transactions between the investor and the investee;

(iv) interchange of managerial personnel; or

(v) provision of essential technical information.

The shareholders' agreement allows Greenie to participate in some decisions. It needs to be determined whether these include financial and operating policy decisions of Manair, although this is very likely. The representation on the board of directors combined with the additional rights Greenie had under the shareholders' agreement, give Greenie the power to participate in some policy decisions. Additionally, Greenie had sent a team of management experts to give business advice to the board of Manair.

In addition, there is evidence of material transactions between the investor and the investee and indications that Greenie provided Manair with maintenance and technical services. Both these facts are examples of how significant influence might be evidenced.

Based on an assessment of all the facts, it appears that Greenie has significant influence over Manair and that Manair should be considered an associate and accounted for using the equity method of accounting.

Finally as it is likely that Manair is an associated undertaking of Greenie the transactions themselves would be deemed related party transactions. Greenie would need to disclose within its own financial statements the relationship, an outline of the transactions including their total value, outstanding balances including any debts deemed irrecoverable or doubtful (LKAS 24 para 17).

31.) Question - LKAS 21 The Effects of Changes in Foreign Exchange Rates

Aspire, a public limited company, operates many of its activities overseas. The directors have asked for advice on the correct accounting treatment of several aspects of Aspire's overseas operations. Aspire's functional currency is Sri Lankan Rupees.

Aspire has a financial statement year end of 30 April 2014 and the average currency exchange rate for the year is not materially different from the actual rate.

Exchange rates	LKR1 = dinars
1 May 2013	5
30 April 2014	6
Average exchange rate for year ended 30 April 2014	5·6

(a) Aspire has created a new subsidiary, which is incorporated in the same country as Aspire. The subsidiary has issued 2 million dinars of equity capital to Aspire, which paid for these shares in dinars. The subsidiary has also raised 100,000 dinars of equity capital from external sources and has deposited the whole of the capital with a bank in an overseas country whose currency is the dinar. The capital is to be invested in dinar denominated bonds. The subsidiary has a small number of staff and its operating expenses, which are low, are incurred in dollars. The profits are under the control of Aspire. Any income from the investment is either passed on to Aspire in the form of a dividend or reinvested under instruction from Aspire. The subsidiary does not make any decisions as to where to place the investments.

Aspire would like advice on how to determine the functional currency of the subsidiary. (7 marks)

Answer

The functional currency is the currency of the primary economic environment in which the entity operates, which is normally the one in which it primarily generates and expends cash. An entity's management considers the following primary indicators in determining its functional currency:

(a) the currency which mainly influences sales prices for goods and services;

(b) the currency of the country whose competitive forces and regulations mainly determine the sales prices of goods and services; and

(c) the currency which mainly influences labour, material and other costs of providing goods and services.

Further secondary indicators which may also provide evidence of an entity's functional currency are the currency in which funds from financing activities are generated and in which receipts from operating activities are retained.

Additional factors are considered in determining the functional currency of a foreign operation and whether its functional currency is the same as that of the reporting entity. These are:

(a) the autonomy of a foreign operation from the reporting entity;

(b) the level of transactions between the two;

(c) whether the foreign operation generates sufficient cash flows to meet its cash needs; and

(d) whether its cash flows directly affect those of the reporting entity.

When the functional currency is not obvious, management uses its judgement to determine the functional currency which most faithfully represents the economic effects of the underlying transactions, events and conditions.

In the case of Aspire, the subsidiary does not make any decisions as to the investment of funds, and consideration of the currency which influences sales and costs is not relevant. Although the costs are incurred in dollars, they are not material to any decision as to the functional currency. Therefore it is important to look at other factors to determine the functional currency. The subsidiary has issued 2 million dinars of equity capital to Aspire, which is a different currency to that of Aspire, but the proceeds have been invested in dinar denominated bonds at the request of Aspire. The subsidiary has also raised 100,000 dinars of equity capital from external sources but this amount is insignificant compared to the equity issued to Aspire. The income from investments is either remitted to Aspire or reinvested on instruction from Aspire. The subsidiary has a minimum number of staff and does not have any independent management. The subsidiary is simply a vehicle for the parent entity to invest in dinar related investments. Aspire may have set up the entity so that any exposure to the dinar/dollar exchange rate will be reported in other comprehensive income through the translation of the net investment in the subsidiary.

There does not seem to be any degree of autonomy as the subsidiary is merely an extension of Aspire's activities. Therefore the functional currency would appear to be the dollar.

In contrast, the dinar represents the currency in which the economic activities of the subsidiary are primarily carried out as is the case regarding the financing of operations and retention of any income not remitted. However, the investment of funds could have been carried out directly by Aspire and therefore the parent's functional currency should determine that of the subsidiary.

(b) On 1 May 2013, Aspire purchased 70% of a multi-national group whose functional currency was the dinar. The purchase consideration was LKR 200 million. At acquisition, the net assets at cost were 1,000 million dinars. The fair values of the net assets were 1,100 million dinars and the fair value of the non-controlling interest was 250 million dinars. Aspire uses the full goodwill method.

Aspire wishes to know how to deal with goodwill arising on the above acquisition in the group financial statements for the year ended 30 April 2014. (5 marks)

<u>Answer</u>

The goodwill arising when a parent acquires a multinational operation with several currencies is allocated to each level of functional currency. Goodwill arising on acquisition of foreign operations and any fair value adjustments are both treated as the foreign operation's assets and liabilities. They are expressed in the foreign operation's functional currency and translated at the closing rate. Exchange differences arising on the retranslation of foreign entities' financial statements are recognised in other comprehensive income and accumulated as a separate component of equity

Exchange rate at 1 May 2013	*LKR1= 5 dinars*
Exchange rate at 30 April 2014	*LKR1= 6 dinars*
Net assets at fair value	*1,100m dinars*
Translated at 1 May 2013	*LKR220m*
Purchase consideration	*LKR200m*
NCI (250m dinars/5)	*LKR50m*
Goodwill	*LKR30m*
Goodwill treated as foreign currency asset at 1 May 2013 (LKR30m x 5)	*150m dinars*
Goodwill translated at closing rate at 30 April 2014 (150m dinars/6)	*LKR25m*
Translation adjustment for goodwill in equity	*(LKR5m)*

An exchange loss of LKR5 million will be charged in other comprehensive income together with any gain or loss on the retranslation of the net assets of the operations.

(c) Aspire took out a foreign currency loan of 5 million dinars at a fixed interest rate of 8% on 1 May 2013. The interest is paid at the end of each year. The loan will be repaid after two years on 30 April 2015. The interest rate is the current market rate for similar two-year fixed interest loans.

Aspire requires advice on how to account for the loan and interest in the financial statements for the year ended 30 April 2014. (5 marks)

<u>Answer</u>

The loan balance, as a monetary item, is translated at the spot exchange rate at the year-end date. Interest is translated at the average rate because it approximates to the actual rate. Because the interest is at a market rate for a similar two-year loan, Aspire measures the loan on initial recognition at the transaction price translated into the functional currency. Because there are no transaction costs, the effective interest rate is 8%.

On 1 May 2013, the loan is recorded on initial recognition as follows:

Dr Cash *LKR1 million*

Cr Loan payable – financial liability	*LKR1 million*

Year ended 30 April 2014

Aspire records the interest expense as follows:

Dr Profit or loss – interest expense	*LKR71,429*
Cr Loan payable – financial liability	*LKR71,429*

To recognise interest payable for the year ended 30 April 2014 (0·4 million dinars/5·6).

On 30 April 2014 the interest is paid and the following entry is made:

Dr Loan payable – financial liability	*LKR66,666*
Cr Cash	*LKR66,666*

To recognise the payment of 2014 interest on financial liability (0·4 million dinars/6).

At 30 April 2014 the loan is recorded at 5 million dinars/6, i.e. LKR833,333, which gives rise to an exchange gain of LKR166,667. In addition to this, a further exchange gain of LKR4,763 arises on the translation of the interest paid (LKR71,429 – 66,666). The total exchange gain is therefore LKR171,430.

32.) Question - SLFRS 11 Joint Arrangements

Bread owns a 25% share in a manufacturing facility which had a total construction cost of $200 million and was completed and ready for use on 31 March 2017. The facility is expected to have a useful life of 20 years. All economic decisions concerning the facility require the unanimous consent of Bread and two other investors who own the remaining 75% of the facility. The investment in the manufacturing facility was correctly deemed to be a joint operation and trading from the facility started from 30 June 2017. Revenues earned from the facility for the period ended 31 December 2017 were $57 million. Production costs for goods sold and other operating costs were $36 million. Bread has not made any accounting entries for the year ended 31 December 2017 in relation to the facility, except for $50 million construction costs included within property, plant and equipment. It has been agreed that profits and losses should be split evenly across the three investors.

Answer

The manufacturing facility is classified as a joint operation as key decisions require unanimous consent and each party has rights to the facility. Bread has correctly included their $50m share of the facility within property, plant and equipment but the asset should have been depreciated from 31 March 2017 as the facility was ready for use. The depreciation adjustment required is $1·9m ($50m/20 x 9/12).

Each investor should include a third of the profits from the facility within their individual accounts. An adjustment of \$19m (\$57m x 1/3) is required to the current assets of Bread and \$12m (\$36m x 1/3) should be added to their current liabilities. Overall, the profits of Bread will increase by \$7m (\$19m – \$12m)

33.) Question - SLFRS 11 Joint Arrangements

Crypto operates in the power industry, and owns 45% of the voting shares in Katie. Katie has four other investors which own the remaining 55% of its voting shares and are all technology companies. The largest of these holdings is 18%. Katie is a property developer and purchases property for its renovation potential and subsequent disposal. Crypto has no expertise in this area and is not involved in the renovation or disposal of the property.

The board of directors of Katie makes all of the major decisions but Crypto can nominate up to four of the eight board members. Each of the remaining four board members are nominated by each of the other investors. Any major decisions require all board members to vote and for there to be a clear majority. Thus, Crypto has effectively the power of veto on any major decision. There is no shareholder agreement as to how Katie should be operated or who will make the operating decisions for Katie. The directors of Crypto believe that Crypto has joint control over Katie because it is the major shareholder and holds the power of veto over major decisions.

The directors of Crypto would like advice as to whether or not they should account for Katie under SLFRS 11 Joint Arrangements. (6 marks)

Answer

Before assessing whether an entity has joint control over an arrangement, an entity must first assess whether the parties control the arrangement in accordance with the definition of control in SLFRS 10 Consolidated Financial Statements. If not, an entity must determine whether it has joint control of the arrangement. SLFRS 11 Joint Arrangements defines joint control as 'the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control'. This means an assessment as to whether any party can prevent any of the other parties from making unilateral decisions without its consent. It must be clear which combination of parties is required to agree unanimously to decisions about the relevant activities of the arrangement. In the case of Katie, there is more than one combination of parties possible to reach the required majority. As a result, Crypto does not have joint control.

In addition to the above, Crypto does not control Katie because SLFRS 10 states that control requires power over the investee which gives the investor the ability to direct the relevant activities. Crypto does not have the ability to direct the relevant activities as it can only block decisions, and cannot make decisions by itself. Also, there is no shareholder agreement which sets out shareholders' voting rights and obligations and thus the other shareholders can act together to prevent Crypto from making decisions in its own interest. Crypto does not have joint control as agreement between itself and other board members has to occur for a decision to be made. Therefore, it appears that Katie is an associate of Crypto and would apply LKAS 28 Investments in Associates and Joint Ventures.

34.) Question - SLFRS 10 Consolidated Financial Statements

Formatt is a listed company with several investments in other entities. The directors currently misunderstand the nature of the control principle within certain International Financial Reporting Standards (SLFRSs) and the Conceptual Framework.

During the year ended 30 November 2017, Formatt entered into a joint venture, Font, with another entity, Loft. Font was structured in such a way that all business decisions were taken by the management committee of Formatt and the only decisions which needed the approval of both Formatt and Loft were those which were outside normal operational decisions. Font was financed initially through the issue of bonds whose return was based upon the performance of the joint venture. Formatt purchased the bonds from third parties during the year.

As a bondholder, Formatt has the right to appoint the general manager of the joint venture. For the year ended 30 November 2017, Formatt intends to account for Font under SLFRS 11 Joint Arrangements. Formatt also holds 49·1% of Protect's voting shares and accounts for Protect as an associate. Protect has 20 other shareholders, the largest of which has a shareholding of 20% and the smallest a holding of 1% of the voting shares. The shareholders have an agreement which gives the largest shareholder a right of first refusal if one of them wishes to sell its shareholding in Protect. The management committee of Protect consisted of six members of whom four were representatives of Formatt. There has not been complete shareholder representation at the last four annual general meetings of Protect.

The directors of Formatt wish to know how to account for Font and Protect in the financial statements for the year ended 30 November 2017. (8 marks)

Required:

Advise the directors of Formatt on how the above elements should be dealt with in its financial statements with reference to relevant SLFRSs and, where necessary, pronouncements on the Conceptual Framework

Answer

According to SLFRS 10 Consolidated Financial Statements, an investor controls an investee when the investor has power over the investee, exposure, or rights, to variable returns from its involvement with the investee and the ability to use its power over the investee to affect the amount of the investor's return.

Formatt makes all of the operational decisions as regards Font and the only decisions which need the approval of both Formatt and Loft are those which are outside normal operational decisions. These are protective rights for Loft and do not prevent Formatt from having power over Font. The concept of returns is quite a broad one and would include a return from the bonds purchased by Formatt in Font. Hence, Formatt has exposure to positive and possibly negative returns as the bondholders' return is based upon the performance of Font. Formatt is therefore exposed to variable returns from its involvement with Font. Formatt also has the right to appoint the general manager of Font and thus, together with the operational control exercised by Formatt, this power can be used to affect the amount of the investor's return. Thus, the conditions set out in SLFRS 10 appear fulfilled, and it can be concluded *that Formatt controls Font. Therefore, Formatt should consolidate Font as a subsidiary in its financial statements as of 30 November 2017.*

As Formatt held 49·1% of the shares of Protect, it does not have a majority. The second highest shareholding is one of 20% which can indicate significant influence but this does not prevent Formatt from controlling Protect. Formatt only needs the support or the absence of one of the other shareholders to hold a majority of the voting rights. Formatt has also been able to sustain a majority representation in the management committee, showing that it can dominate the election process. Additionally, there had not been complete representation of the shareholders at the last four annual general meetings which has meant that Formatt could control the voting at such meetings. In the event of a shareholder wishing to sell its shares, Formatt can protect its position if it so wishes by having first refusal on the purchase of such shares. Therefore, Formatt should consolidate Protect as a subsidiary in its financial statements as of 30 November 2017.

35.) Question - SLFRS 15 Revenue from Contracts with Customers

Carsoon constructs retail vehicle outlets and enters into contracts with customers to construct buildings on their land. The contracts have standard terms, which include penalties payable by Carsoon if the contract is delayed, or payable by the customer, if Carsoon cannot gain access to the construction site.

Due to poor weather, one of the projects was delayed. As a result, Carsoon faced additional costs and contractual penalties. As Carsoon could not gain access to the construction site, the directors decided to make a counter-claim against the customer for the penalties and additional costs which Carsoon faced. Carsoon felt that because claims had been made against the customer, the additional costs and penalties should not be included in contract costs but shown as a contingent liability. Carsoon has assessed the legal basis of the claim and feels it has enforceable rights.

In the year ended 28 February 2017, Carsoon incurred general and administrative costs of $10 million, and costs relating to wasted materials of $5 million.

Additionally, during the year, Carsoon agreed to construct a storage facility on the same customer's land for $7 million at a cost of $5 million. The parties agreed to modify the contract to include the construction of the storage facility, which was completed during the current financial year. All of the additional costs relating to the above were capitalised as assets in the financial statements.

The directors of Carsoon wish to know how to account for the penalties, counter claim and additional costs in accordance with SLFRS 15 Revenue from Contracts with Customers. (7 marks)

Answer

SLFRS 15 Revenue from Contracts with Customers specifies how to account for costs incurred in fulfilling a contract which are not in the scope of another standard. Costs to fulfil a contract which is accounted for under SLFRS 15 are divided into those which give rise to an asset and those which are expensed as incurred. Entities will recognise an asset when costs incurred to fulfil a contract meet certain criteria, one of which is that the costs are expected to be recovered.

For costs to meet the 'expected to be recovered' criterion, they need to be either explicitly reimbursable under the contract or reflected through the pricing of the contract and recoverable through the margin.

The penalty and additional costs attributable to the contract should be considered when they occur and Carsoon should have included them in the total costs of the contract in the period in which they had been notified.

As regards the counter claim for compensation, Carsoon accounts for the claim as a contract modification in accordance with SLFRS 15. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, Carsoon should account for the modification by updating the transaction price and the measure of progress towards complete satisfaction of the performance obligation.

A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations which are created or changed by a modification are enforceable, an entity should consider all relevant facts and circumstances including the terms of the contract and other evidence. On the basis of information available, it is possible to feel that the counter claim had not reached an advanced stage, so that claims submitted to the client could not be included in total revenues.

When the contract is modified for the construction of the storage facility, an additional $7 million is added to the consideration which Carsoon will receive. The additional $7 million reflects the stand-alone selling price of the contract modification. The construction of the separate storage facility is a distinct performance obligation; the contract modification for the additional storage facility would be, in effect, a new contract which does not affect the accounting for the existing contract. Therefore the contract is a performance obligation which has been satisfied as assets are only recognised in relation to satisfying future performance obligations. General and administrative costs cannot be capitalised unless these costs are specifically chargeable to the customer under the contract. Similarly, wasted material costs are expensed where they are not chargeable to the customer. Therefore a total expense of $15 million will be charged to profit or loss and not shown as assets.

36.) Question - SLFRS 15 Revenue from Contracts with Customers

Formatt has entered into a contract with a customer to supply specialised medical equipment. Formatt has developed the equipment in conjunction with the customer but has contracted with a supplier for its manufacture. The supplier delivers the equipment to the customer. Formatt pays the supplier directly and invoices the customer with the agreed selling price which is cost plus 25%. Any equipment defects are the responsibility of Formatt. The directors of Formatt are unsure as to whether they should account for the whole transaction as a principal or just the profit margin as if an agent.

Required:

Advise the directors of Formatt on how the above elements should be dealt with in its financial statements with reference to relevant SLFRSs and, where necessary, pronouncements on the Conceptual Framework

Answer

SLFRS 15 Revenue from Contracts with Customers states that an entity is a principal where the entity controls the promised good before transfer to the customer. However, the entity is an agent where the performance obligation is to arrange provision of the goods by another party. Although Formatt has subcontracted the manufacturing of the equipment to a supplier, the development of the specification, the manufacturing of the equipment, and the overall management of the contract are not distinct because they are not separately identifiable and thus there is a single performance obligation. The customer has contracted with Formatt so that the various elements of the contract are integrated as one obligation.

Therefore, Formatt controls the specialised equipment before the equipment is transferred to the customer and is therefore the principal in this transaction. Formatt is also responsible for any defects. The supplier cannot decide to use the specialized equipment for another purpose as the equipment must be delivered to the customer to fulfil the promise in the contract. Formatt has the responsibility for fulfilling the contract, determines the price of the contract, is not paid on a commission basis and has the credit risk.

37.) Question - SLFRS 15 Revenue from Contracts with Customers

Darlatt is a public limited company with a year end of 31 August 2017. It sells wind turbines as part of a combined contract which includes a standard two-year warranty term and maintenance services for a ten-year period. In addition, Darlatt offers the option of a ten-year extension to the warranty for an additional fee which is paid at the time of the initial sale. The sales price for the combined contract is \$3·6 million and the customer will pay an additional fee of \$0·8 million for the extended warranty. If sold separately, the selling price of the wind turbine would be \$3·2 million and the selling price of the two-year warranty and ten-year maintenance service contract would be \$0·9 million. The extended warranty has a separate selling price of \$1 million.

The directors of Darlatt would like to know how the above transactions should be accounted for under SLFRS 15 Revenue from Contracts with Customers. (8 marks)

Required:

Advise the directors of Darlatt on how the above elements should be dealt with in its financial statements with reference to relevant International Financial Reporting Standards (SLFRSs).

Answer

SLFRS 15 Revenue from Contracts with Customers sets out the core principle that an entity will recognise revenue to depict the transfer of promised goods or services to customers in an amount which reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This principle is delivered through a five-step model. Once the contract with the customer has been identified, step 2 of the model identifies those elements of the contract which should be accounted for separately. The performance obligations should be identified at the beginning of the contract by identifying distinct goods or services in the contract. To do so, the entity should identify all the goods and services which have been promised. The distinct performance obligations are the units of account which determine when and how revenue is recognised. A good or service is distinct only if the customer can *benefit from the good or service either on its own or together with other resources available to the customer and the good or service is separately identifiable from other promises in the contract.*

A customer can benefit from a good or service on its own if it can be used, consumed, or sold to generate economic benefits. Determining whether a good or service is distinct within the context of the contract requires assessment of the contract terms and the intent of the parties. Thus in the case of Darlatt, the entity is required to assess whether the deliverables it has promised to the customer give rise to separate performance obligations. The purchase of the wind turbine and the maintenance contract are obviously separate performance obligations. However, the two warranties require further consideration. The nature of the warranty will determine the accounting impact. SLFRS 15 states that an entity accounts for a warranty as a separate performance obligation if the customer has the option to purchase the warranty separately. An entity accounts for a warranty as a cost accrual if it is not sold separately, unless the warranty is to provide the customer with a service in addition to assurance that the product complies with agreed specifications. The free warranty simply provides the customer with the assurance that the wind turbine meets the agreed specification and thus is not a separate performance obligation. Where the warranty provides an additional service as is the case with the ten-year warranty, then the income will be treated as deferred revenue.

Once the separate performance obligations have been identified, then the transaction price is allocated to them based on the relative stand-alone selling prices of the goods or services promised. This allocation is made at contract inception and not adjusted to reflect subsequent changes in the stand-alone selling prices of those goods or services. The best evidence of stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately.

Therefore, the wind turbine will be allocated with (\$3·2m/\$4·1m x \$3·6m), i.e. \$2·8 million and the maintenance contract with (\$0·9m/\$4·1m x \$3·6m), i.e. \$0·8 million of the total revenue. Thus the maintenance contract and additional warranty will be recognised over time and the sale of the wind turbine and free warranty will be recognised at a point in time. Where revenue is recognised over time, a method should be used which best reflects the pattern of transfer of goods or services to the customer. In this case, it would appear that both of the above elements would be recognised over 10 years

38.) Question - SLFRS 15 Revenue from Contracts with Customers

Zedtech is a software development company which provides data hosting and other professional services. As part of these services, Zedtech also securely hosts a range of inventory management software online which allows businesses to manage inventory from anywhere in the world. It also sells hardware in certain circumstances.

Zedtech sells two distinct software packages. The first package, named 0inventory, gives the customer the option to buy the hardware, professional services and hosting services as separate and distinct contracts. Each element of the package can be purchased without affecting the performance of any other element. Zedtech regularly sells each service separately and generally does not integrate the goods and services into a single contract.

With the second package, InventoryX, the hardware is always sold along with the professional and hosting services and the customer cannot use the hardware on its own. The hardware is integral to the delivery of the hosted software. Zedtech delivers the hardware first, followed by professional services and finally, the hosting services. However, the professional services can be sold on a stand-alone basis as this is a distinct service which Zedtech can offer any customer.

Zedtech has decided to sell its services in a new region of the world which is suffering an economic downturn. The entity expects the economy to recover and feels that there is scope for significant growth in future years. Zedtech has entered into an arrangement with a customer in this region for promised consideration of $3 million. At contract inception, Zedtech feels that it may not be able to collect the full amount from the customer and estimates that it may collect 80% of the consideration.

Required:

(i) Discuss the principles in SLFRS 15 Revenue from Contracts with Customers which should be used by

Zedtech to determine the recognition of the above contracts. (5 marks)

(ii) Discuss how the above contracts should be recognised in the financial statements of Zedtech under

SLFRS 15. (7 marks)

Answer

(i) SLFRS 15 Revenue from Contracts with Customers states that an entity must first identify the contract with the customer and as part of that identification, the entity has to determine whether it is probable that the consideration which the entity is entitled to in exchange for the goods or services will be collected. An assessment of collectability is included as one of the criteria for determining whether a contract with a customer exists.

SLFRS 15 states that the entity must identify the performance obligations in the contract. Once an entity has identified the contract with a customer, it evaluates the contractual terms and its customary business practices to identify all the promised goods or services within the contract and determine which of those promised goods or services will be treated as separate performance obligations. An entity will have to decide whether the obligations are distinct or part of a series of distinct goods and services which are substantially the same and have the same pattern of transfer to the customer. A good or service is distinct if the customer can benefit from the good or service on its own.

(ii) Technology entities often enter into transactions involving the delivery of multiple goods and services.

As regards 0inventory, it seems that all of the individual goods and services in the contract are distinct because the entity regularly sells each element of the contract separately and is not providing the significant service of integrating the goods and services. Also, as the customer could purchase each good and service without significantly affecting the other goods and services purchased, there is no dependence upon individual elements of the service. Thus hardware, professional services and hosting services should each be accounted for as separate performance obligations.

Regarding InventoryX, the professional services are distinct because Zedtech frequently sells those services on a stand‐*alone basis.*

However, the hardware is always sold in a combined contract with the professional and hosting services and the customer cannot use the hardware on its own. As a result, the hardware is not distinct and because the hardware is integral to the delivery of the hosted software, the hardware and hosting services should be accounted for as one performance obligation while the professional services, which are distinct, would be a separate performance obligation.

When performing the collectability assessment, Zedtech only considers the customer's ability and intention to pay the expected consideration when due. Zedtech has entered into an arrangement and does not expect to collect the full contractual amount such that the contract contains an implied price concession. Therefore, Zedtech needs to assess the collectability of the amount to which it expects to be entitled, rather than the stated contractual amount. Zedtech assesses whether collectability is probable, whether the customer has the ability and intent to pay the estimated transaction price. Zedtech will determine that the amount to which it expects to be entitled is \$2·4 million and performs the collectability assessment based on that amount, rather than the contractual price of \$3 million.

39.) Question - SLFRS 15 Revenue from Contracts with Customers & SLFRS 13 Fair Value Measurement & SLFRS 9 / LKAS 32 / SLFRS 7 Financial Instruments & SLFRS 11 Joint Arrangements

Background

Digiwire Co has developed a new business model whereby it sells music licences to other companies which then deliver digital music to consumers.

Revenue: sale of three-year licence

Digiwire Co has agreed to sell Clamusic Co, an unlisted technology start-up company, a three-year licence to sell Digiwire Co's catalogue of classical music to the public. This catalogue contains a large selection of classical music which Digiwire Co will regularly update over the three-year period.

As revenue for the three-year licence, Clamusic Co has issued shares to Digiwire Co equivalent to a 7% shareholding. Voting rights are attached to these shares. Digiwire Co received the shares in Clamusic Co on 1 January 20X6, which is the first day of the licence term.

Digiwire Co will also receive a royalty of 5% of future revenue sales of Clamusic Co as revenue for the licence.

Clamusic Co valuation and revenue

On 1 January 20X6, Clamusic Co was valued at between \$4–\$5 million by a professional valuer who used a market-based approach. The valuation was based on the share price of a controlling interest in a comparable listed company.

For the financial year end of 31 December 20X6, sales of the classical music were \$1 million. At 31 December 20X6, a further share valuation report had been produced by the same professional valuer which indicated that Clamusic Co was valued in the region of \$6–\$7 million.

Investment in FourDee Co

Digiwire Co has agreed to work with TechGame Co to develop a new music platform. On 31 December 20X6, the companies created a new entity, FourDee Co, with equal shareholdings and shares in profit. Digiwire Co has contributed its own intellectual property in the form of employee expertise, cryptocurrency with a carrying amount of $3 million (fair value of $4 million) and an office building with a carrying amount of $6 million (fair value of $10 million). The cryptocurrency has been recorded at cost in Digiwire Co's financial statements. TechGame Co has contributed the technology and marketing expertise. The board of FourDee Co will comprise directors appointed equally by Digiwire Co and TechGame Co. Decisions are made by a unanimous vote.

Required:

(a) Advise the directors of Digiwire Co on the recognition and measurement of the:

(i) Clamusic Co shares received as revenue for the sale of the three-year licence and how they should be accounted for in the financial statements for the year ended 31 December 20X6; and

(ii) royalties which Clamusic Co has agreed to pay as revenue for the sale of the three-year licence in the financial statements for the year ended 31 December 20X6. Your answer to (a)(ii) should demonstrate how it is supported by the revised Conceptual Framework for Financial Reporting (2018). (9 marks)

(b) Based on International Financial Reporting Standards (IFRS®), advise the directors on the following:

(i) the classification of the investment which Digiwire Co has in FourDee Co;

(ii) the derecognition of the assets exchanged for the investment in FourDee Co and any resulting gain/loss on disposal in the financial statements of Digiwire Co at 31 December 20X6; and

(iii) whether the cryptocurrency should be classified as a financial asset or an intangible asset. Your answer should also briefly consider whether fair value movements on the cryptocurrency should be recorded in profit or loss. (9 marks)

Answer

(a) (i) Revenue recognition: Clamusic Co shares

IFRS 15 Revenue from Contracts with Customers requires that non-cash consideration received should be measured at the fair value of the consideration received. If fair value cannot be reasonably estimated, the consideration should be measured by reference to the stand-alone selling price of the good or service promised in the contract. The fair value of non-cash consideration may vary. If the non-cash consideration varies for reasons other than the form of the consideration, entities will apply the guidance in IFRS 15 related to constraining variable consideration. However, if fair value varies only due to the form, the variable constraint guidance in IFRS 15 would not apply. In this case, the fair value varies due to the form of the consideration which is equity shares and therefore the variable constraint guidance in IFRS 15 does not apply.

The fair valuation of shares in an unlisted start-up company is problematic. However, IFRS 13 Fair Value Measurement gives advice on how to measure unlisted shares. It sets out three approaches: (i) market approach, such as the transaction price paid for identical or similar instruments of an investee; (ii) the income approach, for example, using discounted cash flow; and (iii) the adjusted net asset approach.

In this case, the market approach has been used and the range of fair values is significant based upon the professional valuation report. The range of fair values for a 7% holding of shares would be $280,000 to $350,000 (7% of $4–$5 million) at the date of the contract and $420,000 to $490,000 (7% of $6–$7 million) at the year end. As the fair valuation is based upon a similar listed company and is based upon a controlling interest, a discount on the valuation of the shares should be applied to reflect the lack of liquidity and inability to participate in Digiwire Co's policy decisions. Thus an estimated value of the shares can be made which takes into account the above facts. This could be the mid-point of $315,000 (($280,000 + $350,000)/2) at the date of the contract and $455,000 (($420,000 + $490,000)/2) at the year end. Digiwire Co would therefore recognise revenue of $315,000 for the receipt of shares from Clamusic Co, as the fair value of non-cash consideration is measured at the contract inception date of 1 January 20X6. This revenue would not be recognised at a point in time but would be recognised over the period of the licence which is three years.

Clamusic Co share valuation at 31 December 20X6

The shares will be recognised at $455,000 (($420,000 + $490,000)/2) at 31 December 20X6. All equity investments in scope of IFRS 9 Financial Instruments should be measured at fair value in the statement of financial position, with value changes being recognised in profit or loss. If an equity investment is not held for trading, an entity can make an irrevocable election at initial recognition to measure it at fair value through other comprehensive income (FVTOCI) with only dividend income recognised in profit or loss.

If Digiwire Co elects to present the remeasurements through other comprehensive income (OCI), gains are never recycled through profit or loss. This means that, if the investment in Clamusic Co is successful, when the investment is sold, there will be no profit or loss effect since all gains will already have been recognised in OCI. Thus at the year end, a gain of $140,000 ($455,000 – $315,000) will be recorded in profit or loss or OCI dependent upon any election being made.

(ii) Revenue: royalties

As Digiwire Co retains an active role in the updating and maintenance of a sold licence to ensure its continuing value to the client, revenue would be recognised over the expected length of the contract or related client relationship. An entity must be expected to undertake activities which significantly affect the licence to conclude that revenue is recognised over time. However, reliable measurement of future royalties is not available. Thus, in this case, the revenue would be recognised over the three-year licence based upon the licence agreement. At the year end, however, revenue from royalties can be calculated based upon the sales for the period and it would be $50,000 (5% of $1 million).

(b) (i) It seems that Digiwire Co and TechGame jointly control FourDee Co and it appears as though the arrangement is a joint venture (IFRS 11 Joint Arrangements) as the parties have joint control of the arrangement and have rights to the net assets of the arrangement. Joint control is the contractually agreed sharing of control of an arrangement, which exists only

when decisions about the relevant activities require the unanimous consent of the parties sharing control. This is the case with FourDee Co. A joint venturer recognises its interest in a joint venture as an investment and accounts for that investment using the equity method in accordance with IAS 28 Investments in Associates and Joint Ventures unless the entity is exempted.

(ii) Digiwire Co has exchanged non-monetary assets for its investment in FourDee Co, and thus needs to de-recognise the assets it is contributing to FourDee Co. The carrying amount of $6 million of the property is derecognised but the intellectual property of Digiwire Co has been generated internally and does not have a carrying amount. The cryptocurrency is recorded as an asset in the financial statements of Digiwire Co at $3 million but will be valued at $4 million, its fair value in the financial statements of FourDee Co.

Accordingly, when a joint venturer contributes a non-monetary asset to a joint venture in exchange for an equity interest in the joint venture, the joint venturer recognises a portion of the gain or loss on disposal which is attributable to the other parties to the joint venture (except when the contribution lacks commercial substance). Essentially, Digiwire Co is required by IAS 28 to limit the profit on disposal of its non-monetary assets to 50%. Effectively, Digiwire has only disposed of 50% of the asset contributed to the joint venture. Thus the carrying amount of the joint venture in Digwire's financial statements at 31 December 20X6 will be $11·5 million (($6 + $3 carrying amounts derecognised for property and cryptocurrency) + ((4 – 3)/2) + ((10 – 6)/2)). A gain of $2·5 million will be recorded in profit or loss.

(iii) If the cryptocurrency meets the definition of a financial asset, it is possible to measure it at fair value. However, cryptocurrency is not cash or cash equivalents as its value is exposed to significant changes in market value and there is no contractual right to receive either cash or cash equivalents. Therefore, cryptocurrency fails the definition of a financial asset.

If the cryptocurrency is to be recognised as an intangible asset, then the default position would be to measure it at cost. However, there may be an argument to say that there is an active market for the cryptocurrency in which case, it would be possible for it to be measured at fair value. In this case, movements in that fair value would be recognised through other comprehensive income and the gain would not be recycled through profit or loss when the cryptocurrency is realised.

The best way to account for a cryptocurrency would be fair value as that is the value at which the entity will realise their investment or transact in exchange for goods and services. Accounting for cryptocurrency at fair value with movements reflected in profit or loss would provide the most useful information to investors but existing accounting requirements do not appear to permit this.

40.) Question - SLFRS 13 Fair Value Measurement

The directors of Yanong, a public limited company, have seen many different ways of dealing with the measurement and disclosure of the fair value of assets, liabilities and equity instruments. They feel that this reduces comparability among different entities' financial statements. They would like advice on several transactions where they currently use fair value measurement as they have heard that the introduction of SLFRS 13 Fair Value Measurement, while not interfering with the scope of fair value measurement, will reduce the extent of any diversity and inconsistency.

(a) Yanong owns several farms and also owns a division which sells agricultural vehicles. It is considering selling this agricultural retail division and wishes to measure the fair value of the inventory of vehicles for the purpose of the sale. Three markets currently exist for the vehicles. Yanong has transacted regularly in all three markets.

At 30 April 2015, Yanong wishes to find the fair value of 150 new vehicles, which are identical. The current volume and prices in the three markets are as follows:

Market	Sales price per vehicle - $	Historical volume vehicles sold by Yanong	Total volume of vehicles sold in market	Transaction cost per vehicle - $	Transport cost to the market - per vehicle - $
Europe	40,000	6,000	150,000	500	400
Asia	38,000	2,500	750,000	400	700
Africa	34,000	1,500	100,000	300	600

Yanong wishes to value the vehicles at $39,100 per vehicle as these are the highest net proceeds per vehicle, and Europe is the largest market for Yanong's product. Yanong would like advice as to whether this valuation would be acceptable under SLFRS 13 Fair Value Measurement. (6 marks)

Answer

SLFRS 13 says that fair value is an exit price in the principal market, which is the market with the highest volume and level of activity. It is not determined based on the volume or level of activity of the reporting entity's transactions in a particular market. Once the accessible markets are identified, market-based volume and activity determines the principal market. There is a presumption that the principal market is the one in which the entity would normally enter into a transaction to sell the asset or transfer the liability, unless there is evidence to the contrary. In practice, an entity would first consider the markets it can access. In the absence of a principal market, it is assumed that the transaction would occur in the most advantageous market. This is the market which would maximise the amount which would be received to sell an asset or minimise the amount which would be paid to transfer a liability, taking into consideration transport and transaction costs. In either case, the entity must have access to the market on the measurement date. Although an entity must be able to access the market at the measurement date, SLFRS 13 does not require an entity to be able to sell the particular asset or transfer the particular liability on that date. If there is a principal market for the asset or liability, the fair value measurement represents the price in that market at the measurement date regardless of whether that price is directly *observable or estimated using another valuation technique and even if the price in a different market is potentially more advantageous. The principal (or most advantageous) market price for the same asset or liability might be different for different entities and therefore, the principal (or most advantageous) market is considered from the entity's perspective which may result in different prices for the same asset.*

In Yanong's case, Asia would be the principal market as this is the market in which the majority of transactions for the vehicles occur. As such, the fair value of the 150 vehicles would be $5,595,000 ($38,000 – $700 = $37,300 x 150). Actual sales of the vehicles in either Europe or Africa would result in a gain or loss to Yanong when compared with the fair value, i.e. $37,300. The most advantageous market would be Europe where a net price of $39,100 (after all costs) would be gained by selling there and the number of vehicles sold in this market by Yanong is at its highest. Yanong would therefore utilise the fair value calculated by reference to the Asian market as this is the principal market.

The IASB decided to prioritise the price in the most liquid market (i.e. the principal market) as this market provides the most reliable price to determine fair value and also serves to increase consistency among reporting entities.

SLFRS 13 makes it clear that the price used to measure fair value must not be adjusted for transaction costs, but should consider transportation costs. Yanong has currently deducted transaction costs in its valuation of the vehicles. Transaction costs are not deemed to be a characteristic of an asset or a liability but they are specific to a transaction and will differ depending on how an entity enters into a transaction. While not deducted from fair value, an entity considers transaction costs in the context of determining the most advantageous market because the entity is seeking to determine the market which would maximise the net amount which would be received for the asset.

41.) Question - SLFRS 13 Fair Value Measurement

Yanong uses the revaluation model for its non-current assets. Yanong has several plots of farmland which are unproductive. The company feels that the land would have more value if it were used for residential purposes. There are several potential purchasers for the land but planning permission has not yet been granted for use of the land for residential purposes. However, preliminary enquiries with the regulatory authorities seem to indicate that planning permission may be granted. Additionally, the government has recently indicated that more agricultural land should be used for residential purposes.

Yanong has also been approached to sell the land for commercial development at a higher price than that for residential purposes.

Yanong would like advice on how to measure the fair value of the land in its financial statements. (5 marks)

<u>Answer</u>

A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant who would use the asset in its highest and best use. The maximum value of a non-financial asset may arise from its use in combination with other assets or by itself. SLFRS 13 requires the entity to consider uses which are physically possible, legally permissible and financially feasible. The use must not *be legally prohibited. For example, if the land is protected in some way by law and a change of law is required, then it cannot be the highest and best use of the land. In this case, Yanong's land for residential development would only require approval from the regulatory authority and that approval seems to be possible, then this alternative use could be deemed to be legally permissible. Market participants would consider the probability, extent and timing of the approval which may be required in assessing whether a change in the legal use of the non-financial asset could be obtained.*

Yanong would need to have sufficient evidence to support its assumption about the potential for an alternative use, particularly in light of SLFRS 13's presumption that the highest and best use is an asset's current use. Yanong's belief that planning permission was possible is unlikely to be sufficient evidence that the change of use is legally permissible. However, the fact the government has indicated that more agricultural land should be released for residential purposes may provide additional evidence as to the likelihood that the land being measured should be based upon residential value. Yanong would need to prove that market participants would consider residential use of the land to be legally permissible. Provided there is sufficient evidence to support these assertions, alternative uses, for example, commercial development which would enable market participants to maximise value, should be considered, but a search for potential alternative uses need not be exhaustive. In addition, any costs to transform the land, for example, obtaining planning permission or converting the land to its alternative use, and profit expectations from a market participant's perspective should also be considered in the fair value measurement.

If there are multiple types of market participants who would use the asset differently, these alternative scenarios must be considered before concluding on the asset's highest and best use. It appears that Yanong is not certain about what constitutes the highest and best use and therefore SLFRS 13's presumption that the highest and best use is an asset's current use appears to be valid at this stage.

42.) Question - SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations

At 1 April 2009 Cate had a direct holding of shares giving 70% of the voting rights in Date. In May 2010, Date issued new shares, which were wholly subscribed for by a new investor. After the increase in capital, Cate retained an interest of 35% of the voting rights in its former subsidiary Date. At the same time, the shareholders of Date signed an agreement providing new governance rules for Date. Based on this new agreement, Cate was no longer to be represented on Date's board or participate in its management. As a consequence Cate considered that its decision not to subscribe to the issue of new shares was equivalent to a decision to disinvest in Date. Cate argued that the decision not to invest clearly showed its new intention not to recover the investment in Date principally through continuing use of the asset and was considering selling the investment. Due to the fact that Date is a separate line of business (with separate cash flows, management and customers), Cate considered that the results of Date for the period to 31 May 2010 should be presented based on principles provided by SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

Discuss whether the investment in Date can be classified as a Non Current Assets Held for Sale. (5 marks)

<u>Answer</u>

SLFRS 5 states that if there is an intention to dispose of a controlling interest in a subsidiary which meets the definition of 'held for sale', then the net assets are classified as 'held for sale', irrespective of whether the parent was expected to retain an interest after the disposal. A partial disposal of an interest in a subsidiary in which the parent company loses control but retains an interest as an associate or trade investment creates the recognition of a gain or loss on the entire interest. A gain or loss is recognised on the part that has been disposed of and a further holding gain or loss is recognised on the interest retained, being the difference between the fair value of the interest and the book value of the interest. The gains are recognised in the statement of profit or loss. Any prior gains or loss recognised in other components of equity would now become realised in the statement of profit or loss.

In this case, Cate should stop consolidating Date on a line-by-line basis from the date that control was lost. Further investigation is required into whether the holding is treated as an associate or trade investment. The agreement that Cate is no longer represented on the board or able to participate in management would suggest loss of significant influence despite the 35% of voting rights retained. The retained interest would be recognised at fair value.

An entity classifies a disposal group as held for sale if its carrying amount will be recovered mainly through selling the asset rather than through usage and intends to dispose of it in a single transaction.

The conditions for a non-current asset or disposal group to be classified as held for sale are as follows:

(i) The assets must be available for immediate sale in their present condition and its sale must be highly probable.

(ii) The asset must be currently marketed actively at a price that is reasonable in relational to its current fair value.

(iii) The sale should be completed or expected to be so, within a year from the date of the classification.

(iv) The actions required to complete the planned sale will have been made and it is unlikely that the plan will be significantly changed or withdrawn.

(v) management is committed to a plan to sell.

Cate has not met all of the conditions of SLFRS 5 but it could be argued that the best presentation in the financial statements was that set out in SLFRS 5 for the following reasons.

The issue of dilution is not addressed by SLFRS and the decision not to subscribe to the issue of new shares of Date is clearly a change in the strategy of Cate. Further, by deciding not to subscribe to the issue of new shares of Date, Cate agreed to the dilution and the loss of control which could be argued is similar to a decision to sell shares while retaining a continuing interest in the entity. Also Date represents a separate line of business, which is a determining factor in SLFRS 5, and information disclosed on SLFRS 5 principles highlights the impact of Date on Cate's financial statements. Finally, the agreement between Date's shareholders confirms that Cate has lost control over its former subsidiary.

Therefore, in the absence of a specific Standard or Interpretation applying to this situation, LKAS 8 Accounting policies, changes in accounting estimates and errors states that management should use its judgment and refer to other SLFRS and the Framework.

Thus considering the requirements of LKAS 27 (Para 32–37) and the above discussion, it could be concluded that the presentation based on SLFRS 5 principles selected by the issuer was consistent with the accounting treatment required by LKAS 27 when a parent company loses control of a subsidiary.

43.) Question - SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations

Minco acquired a property for Rs.4 million and annual depreciation of Rs.300,000 is charged on the straight line basis. At the end of the previous financial year of 31 May 2013, when accumulated depreciation was Rs.1 million, a further amount relating to an impairment loss of Rs.350,000 was recognised, which resulted in the property being valued at its estimated value in use. On 1 October 2013, as a consequence of a proposed move to new premises, the property was classified as held for sale. At the time of classification as held for sale, the fair value less costs to sell was Rs.2·4 million. At the date of the published interim financial statements, 1 December 2013, the property market had improved and the fair value less costs to sell was reassessed at Rs.2·52 million and at the year end on 31 May 2014 it had improved even further, so that the fair value less costs to sell was Rs.2·95 million. The property was sold on 5 June 2014 for Rs.3 million. (6 marks)

<u>**Answer**</u>

LKAS 34 Interim Financial Reporting requires an entity to apply the same accounting policies in its interim financial statements as are applied in its annual financial statements. Measurements should be made on a 'year to date' basis. In valuing the property, Minco should use the provisions of SLFRS 5 Assets held for Sale and Discontinued Operations. Immediately before the initial classification of the asset as held for sale, the carrying amount of the asset should be measured in accordance with applicable SLFRSs. After classification as held for sale, the property should be measured at the lower of carrying amount and fair value less costs to sell. Impairment must be considered both at the time of classification as held for sale and subsequently in accordance with the applicable SLFRSs. Any impairment loss is recognised in profit or loss unless the asset has previously been measured at a revalued amount under LKAS 16 or LKAS 38, in which case the impairment is treated as a revaluation decrease. A gain for any subsequent increase in fair value less costs to sell of an asset is recognised in the profit or loss to the extent that it is not in excess of the cumulative impairment loss which has been recognised in accordance with SLFRS 5 or previously in accordance with LKAS 36.

At the time of classification as held for sale, depreciation needs to be charged for the four months to 1 October 2013. This will be based upon the year end value at 31 May 2013 of \$2·65 million. The property has 10 years life remaining based upon the depreciation to date and assuming a zero residual value, the depreciation for the four months will be approximately \$0·1 million. Thus, at the time of classification as held for sale, after charging depreciation for the four months of \$0·1 million, the carrying amount is \$2·55 million (\$4m – \$1 – \$0·1m – \$0·35m) and fair value less costs to sell is assessed at \$2·4 million. Accordingly, the initial write-down on classification as held for sale is \$150,000 and the property is carried at \$2·4 million. On 1 December 2013 in the interim financial statements, the property market has improved and fair value less costs to sell is reassessed at \$2·52 million. The gain of \$120,000 is less than *the cumulative impairment losses recognised to date ($350,000 plus $150,000, i.e. $500,000). Accordingly, it is credited in profit or loss and the property is carried at $2·52 million. On 31 May 2014, the property market has continued to improve, and fair value less costs to sell is now assessed at $2·95 million. The further gain of $430,000 is, however, in excess of the cumulative impairment losses recognised to date ($350,000 plus $150,000 – $120,000 – $430,000, i.e. $50,000). Accordingly, a restricted gain of $380,000 is credited in profit or loss and the property is carried at $2·9 million. Subsequently, the property is sold for $3 million at which point a gain of $100,000 is recognised. This sale would be a non-adjusting event under LKAS 10 Events after the Reporting Period if deemed to be material.*

44.) Question - SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations

At 31 August 2016, Evolve controlled a wholly owned subsidiary, Resource, whose only assets were land and buildings, which were all measured in accordance with International Financial Reporting Standards. On 1 August 2016, Evolve published a statement stating that a binding offer for the sale of Resource had been made and accepted and, at that date, the sale was expected to be completed by 31 August 2016. The non-current assets of Resource were measured at the lower of their carrying amount or fair value less costs to sell at 31 August 2016, based on the selling price in the binding offer. This measurement was in accordance with SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations. However, Evolve did not classify the non-current assets of Resource as held for sale in the financial statements at 31 August 2016 because there were uncertainties regarding the negotiations with the buyer and a risk that the agreement would not be finalised.

There was no disclosure of these uncertainties and the original agreement was finalised on 20 September 2016. (9 marks)

Answer

The non-current assets of Resource should have been presented as held for sale in the financial statements, in accordance with SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations, as at 31 August 2016. SLFRS 5 states that the appropriate level of management must be committed to a plan to sell the asset for the sale to be probable. Evolve's acceptance of a binding offer in August 2016 and the publication of this information indicated a high probability of sale. Despite the uncertainties surrounding the sale, the transaction remained highly probable at 31 August 2016. SLFRS 5 requires an entity to classify a non-current asset as held for sale if its carrying amount will be recovered principally through sale rather than through continuing use.

SLFRS 5 does not require the existence of a binding sales agreement in order to classify a non-current asset as held for sale but only a high probability of its occurrence. The acceptance of an offer by Evolve indicates that the transaction met the criteria to be classified as held for sale at 31 August 2016. The finalisation of the agreement on 20 September 2016 only confirmed the situation existing at 31 August 2016. Further, Evolve cannot apply SLFRS 5 measurement criteria without classifying the item as held for sale in its statement of financial position particularly as a profit or impairment may arise when using such criteria. SLFRS 5 also states that immediately before the initial classification of the asset as held for *sale, the carrying amount of the asset should be measured in accordance with applicable SLFRSs. This was already the case as regards the non-current assets of Resource.*

Other criteria which indicate that the non-current assets should be shown as held for sale include the fact that a buyer for the non-current assets has been found, the sale occurred within 12 months of classification as held for sale, the asset was actively marketed for sale at a sales price which has been accepted, and despite the uncertainties at 31 August 2016, events after the reporting period indicate that the contract was not significantly changed or withdrawn. The fact that the information regarding the uncertainties was not publicly disclosed is irrelevant.

Thus as the non-current assets met the criteria to be classified as held for sale, they should have been measured and presented as such in the financial statements. Assets classified as held for sale must be presented separately on the face of the statement of financial position.

45.) Question - SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations

Bread acquired all of the equity shares in Jam on 1 January 2015 for a consideration of $1,250 million. The carrying amount and fair value of the identifiable net assets at acquisition were $1,230 million. At 31 December 2017, Bread was in the process of selling its entire shareholding in Jam and so it was decided that Jam should be treated as a disposal group held for sale in accordance with SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations at that date. The carrying amounts of Jam's net assets before classification as held for sale at 31 December 2017 in the individual financial statements are as follows:

	$m
Property, plant and equipment	836
Intangibles (excluding goodwill)	428
Current assets (at recoverable amount)	584
Non-current liabilities	(322)
Current liabilities	(254)
Total	1,272

The group has a policy of revaluing its property, plant and equipment in accordance with LKAS 16 Property, Plant and Equipment. There have been no revaluations or any other gains or losses included within Jam's other components of equity since the date of acquisition as the carrying amount was deemed to be a close enough approximation to fair value. However, at 31 December 2017, property with a carrying amount of $330 million was deemed to have a fair value of $340 million. No adjustment has yet been made for this fair value.

The total fair value less costs to sell of the disposal group at 31 December was estimated to be $1,220 million. There have been no previous impairments to the goodwill of Jam.

Answer

Goodwill in Jam would originally be calculated as $20m ($1,250m – $1,230m). The net assets Jam are now $1,292m at 31 December 2017 ($1,272m per question and $20m goodwill).

Since the group has a revaluation policy under LKAS 16 Property, Plant and Equipment, the group must revalue the property plant and equipment of Jam to fair value of \$340m on classification as held for sale. A gain of \$10m (\$340m – \$330m) would be recorded within other components of equity (W14). The net assets of Jam would now have a carrying amount of \$1,302m including \$846m for property, plant and equipment. On classification as held for sale, Jam must be measured at the lower of carrying amount and fair value less costs to sell. An impairment arises of \$82 million (\$1,302m – \$1,220m). This will first be allocated to the goodwill of \$20m. The remaining impairment of \$62 million is allocated to non-current assets to which the measurement requirements of SLFRS5 Non-current Assets Held for Sale and Discontinued Operations apply. No impairment will therefore be allocated to the current assets of Jam.

Tutorial note:

The remaining impairment loss of \$62 million should be allocated to property, plant and equipment and other intangible assets in proportion to their respective carrying amounts as follows:

Property, plant and equipment \$62m x (\$846m/(\$846m + \$428m)) = \$41m

Other intangible assets \$62m x (\$428m/(\$846m + \$428m)) = \$21m

or:

The table below summarises the allocation of the impairment

	Carrying amount before reclassified as held for sale \$m	Allocated impairment	Carrying amount after allocation of impairment loss \$m
Goodwill	20	(20)	Nil
Property, plant and equipment	846	(41)	805
Other intangible assets	428	(21)	407
Current assets	584	Nil	584
Non-current liabilities	(322)	Nil	(322)
Current liabilities	(254)	Nil	(254)
Total	1,302	(82) (W12)	1,220

The assets and the liabilities of the disposal group should be separately presented within the current assets and current liabilities of the consolidated financial statements. \$1,796m (\$805m + \$407m + \$584m) or (836 + 10 + 428 – 62 + 584) will be included within current assets and \$576m (\$322m + \$254m) within current liabilities.

46.) Question - SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations

The directors of Bread have been reviewing their classification of Jam as held for sale within SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations. Jam operates in the electricity generation industry which is highly regulated. It is thought that it is highly probable that a purchaser would be found for Jam shortly after 31 December 2017 but that any sale would be subject to regulatory approval which could extend the period beyond 31 December 2018. Actions required to comply with regulatory approval cannot be initiated until a purchase commitment is obtained from the prospective acquirer. In the meantime, Jam will continue to supply electricity to its existing customers. Bread intends to sell all of its shares to the new purchaser who would obtain all of Jam's rights and obligations. The directors of Jam do not intend to sell off any significant assets on an individual basis as this could impact on their supply of electricity to their customers and ultimately affect the sales price of the shares.

Required:

Discuss why the directors of Bread were correct to classify the proposed sale of Jam as a disposal group held for sale within the context of SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations. (6 marks)

Answer

SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations classifies a non-current asset or a disposal group as held for sale if its carrying amount will be recovered principally through a sales transaction rather than through continuing use. The standard clarifies whether the recovery of the assets would be deemed to be a sales transaction. For Bread to classify Jam as a disposal group held for sale, the following criteria must all be met as at 31 December 2017:

(i) it must be actively marketed at a price which is reasonable;

(ii) it must be available for immediate sale in its present condition, subject only to terms which are usual and customary;

(iii) the sale must be highly probable and expected to be completed by 31 December 2018;

(iv) management is committed to a plan to dispose of Jam and that it is unlikely that there would be any significant changes to the plan.

Jam is planning to continue to supply electricity to its existing customers and the sale cannot go through without regulatory approval. It would appear usual and customary for Jam to continue to supply its customers until the sale takes place. A failure to do so would impact on the reputation of Jam and the valuation of the company. The industry is also highly regulated and it would not be deemed unusual to be unable to take action to comply with regulatory conditions until an acquirer is found. It can be concluded that Jam is available for sale in its present condition as at 31 December 2017. The regulatory approval may extend the sales period beyond 31 December 2018. However, the criteria for the sale to be completed within 12 months is relaxed where the sale requires regulatory approval providing that the other conditions are met and that it is highly probable that a firm commitment to acquire Jam can be obtained within one year. Bread is confident that a purchaser will be found shortly after the year end so it appears that the directors did correctly classify Jam as held for sale at 31 December 2017. A further issue arises as to whether Jam should be classified as a disposal group. A disposal group is defined as a group of assets and liabilities directly associated with the assets which are to be sold or transferred within a single transaction.

Therefore any assets which are to be sold individually or any liabilities which are not to be transferred to the acquirer should not be included within the disposal group held for sale. Any assets which are to be *sold individually would still potentially be held for sale but should be valued at the lower of cost and fair value less costs to sell on an individual basis. However, it is Bread's intention to sell its shareholding rather than any individual assets. The acquirer would also obtain all of the rights and obligations which pertain to Jam. It therefore seems appropriate to treat all of the net assets including the goodwill of Jam as a disposal group held for sale.*

47.) Question - SLFRS 8 Operating Segments

Traveler has three distinct business segments. The management has calculated the net assets, turnover and profit before common costs, which are to be allocated to these segments. However, they are unsure as to how they should allocate certain common costs and whether they can exercise judgement in the allocation process. They wish to allocate head office management expenses; pension expense; the cost of managing properties and interest and related interest bearing assets. They also are uncertain as to whether the allocation of costs has to be in conformity with the accounting policies used in the financial statements.

Traveler seeks your guidance in in relation to this.

Answer

SLFRS 8 does not prescribe how centrally incurred expenses and central assets should be allocated to segments. However, allocation of costs and expenses is an area where the basis chosen by an entity can have a significant effect on the segment results. SLFRS 8, however, does require that amounts be allocated on a reasonable basis. The head office management costs could be allocated on the basis of turnover or net assets. The basis of allocation will significantly affect the results. The pension expense may be allocated on the number of employees or salary expense of each segment. Allocating the expense to a segment with no pensionable employees would however not be reasonable. The costs of managing properties could be allocated on the basis of the type, value and age of the properties used by each segment. Different bases can be appropriate for each type of cost. The standard does not require allocation of costs to be on a consistent basis. An entity may allocate interest to a segment profit or loss but does not have to allocate the related interest-bearing asset to the segment assets or liabilities. SLFRS 8 calls this asymmetrical allocation.

SLFRS 8 requires the information presented to be the same basis as it is reported internally, even if the segment information does not comply with SLFRS or the accounting policies used in the consolidated financial statements. Examples of such situations include segment information reported on a cash basis (as opposed to an accruals basis), and reporting on a local GAAP basis for segments that are comprised of foreign subsidiaries. Although the basis of measurement is flexible, SLFRS 8 requires entities to provide an explanation of:

(i) the basis of accounting for transactions between reportable segments;

(ii) the nature of any differences between the segments' reported amounts and the consolidated totals.

For example, those resulting from differences in accounting policies and policies for the allocation of centrally incurred costs that are necessary for an understanding of the reported segment information. In *addition, SLFRS 8 requires reconciliations between the segments' reported amounts and the consolidated financial statements.*

48.) Question - LKAS 16 Property, plant and equipment / LKAS 37 Provisions, Contingent Liabilities and Contingent Assets

Minco leased its head office during the current accounting period and the agreement terminates in six years' time. There is a clause in the operating lease relating to the internal condition of the property at the termination of the lease. The clause states that the internal condition of the property should be identical to that at the outset of the lease. Minco has improved the building by adding another floor to part of the building during the current accounting period. There is also a clause which enables the landlord to recharge Minco for costs relating to the general disrepair of the building at the end of the lease. In addition, the landlord can recharge any costs of repairing the roof immediately. The landlord intends to replace part of the roof of the building during the current period.

Discuss how should Minco account for the addition of the new floor and the cost of disrepair (5 marks)

<u>**Answer**</u>

As regards the improvements to the building through adding an extra floor, Minco should capitalise the costs of the floor in accordance with LKAS 16 Property, Plant and Equipment and amortise these costs over the six years of the lease. However, Minco has an obligation to remove the floor at the end of the lease. The obligation arises because the completion of the floor creates an obligation event. A provision should be made for the present value of the cost of removal of the floor in six years' time. At the same time an asset should be recognised for the cost. The cost should be recovered from the benefits generated by the new floor over the remainder of the lease. The asset should be amortised over the six-year period. In effect, this is in substance a decommissioning activity.

As regards the disrepair of the building, the estimated costs should be spread over the six years of the agreement. LKAS 37 Provisions, Contingent Liabilities and Contingent Assets would indicate that Minco has a present obligation arising from the lease agreement because the landlord can recharge the costs of any repair to Minco. The obligating event is the wear and tear to the building which will arise gradually over the tenancy period and its repair can be enforced through the legal agreement. The obligation relates to wear and tear and is not related to future operating costs. The wear and tear will result in an outflow of economic benefits and a reliable estimate of the yearly obligation arising from this will be made, although it will not necessarily equate to one sixth per year. As regards the roof repair, it is clear from the lease that an obligation exists and therefore a provision should be made for the whole of the rectification work when the need for the repair was identified.

49.) Question - LKAS 16 Property, plant and equipment

Kayte's vessels constitute a material part of its total assets. The economic life of the vessels is estimated to be 30 years, but the useful life of some of the vessels is only 10 years because Kayte's policy is to sell these vessels when they are 10 years old. Kayte estimated the residual value of these vessels at sale to be half of acquisition cost and this value was assumed to be constant during their useful life. Kayte argued that the estimates of residual value used were conservative in view of an immature market with a high degree of uncertainty and presented documentation which indicated some vessels were being sold for a price considerably above carrying value. Broker valuations of the residual value were considerably higher than those used by Kayte. Kayte argued against broker valuations on the grounds that it would result in greater volatility in reporting.

Kayte keeps some of the vessels for the whole 30 years and these vessels are required to undergo an engine overhaul in dry dock every 10 years to restore their service potential, hence the reason why some of the vessels are sold. The residual value of the vessels kept for 30 years is based upon the steel value of the vessel at the end of its economic life. At the time of purchase, the service potential which will be required to be restored by the engine overhaul is measured based on the cost as if it had been performed at the time of the purchase of the vessel. In the current period, one of the vessels had to have its engine totally replaced after only eight years. Normally, engines last for the 30-year economic life if overhauled every 10 years. Additionally, one type of vessel was having its funnels replaced after 15 years but the funnels had not been depreciated separately.

Required:

Discuss the accounting treatment of the above transactions in the financial statements of Kayte. (11 marks)

<u>Answer</u>

Kayte's calculation of the residual value of the vessels with a 10-year useful life is unacceptable under LKAS 16 Property, Plant and Equipment because estimating residual value based on acquisition cost does not comply with the requirements of LKAS 16. Kayte should prepare a new model to determine residual value which would take account of broker valuations at the end of each reporting period and which would produce zero depreciation charge when estimated residual value was higher than the carrying amount.

LKAS 16 paragraph 6 defines residual value as the estimated amount which an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already at the age and in the condition expected at the end of its useful life.

LKAS 16 requires the residual value to be reviewed at least at the end of each financial year end with the depreciable amount of an asset allocated on a systematic basis over its useful life. LKAS 16 specifies that the depreciable amount of an asset is determined after deducting its residual value.

Kayte's original model implied that the residual value was constant for the vessel's entire useful life. The residual value has to be adjusted especially when an expected sale approaches, and the residual value has to come closer to disposal proceeds minus disposal costs at the end of the useful life. LKAS 16 says that in cases when the residual value is greater than the asset's carrying amount, the depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount. The residual value should be the value at the reporting date as if the vessel were already of the age and in the condition expected at the end of its useful life. An increase in the expected residual value of an asset because of past events will affect the depreciable amount, while expectation of future changes in *residual value other than the effects of expected wear and tear will not. There is no guidance in LKAS 16 on how to estimate residual value when the useful life is considered to be shorter than the economic life. Undesirable volatility is not a convincing argument to support the accounting treatment, and broker valuations could be a useful starting point to estimate residual value.*

As regards the vessels which are kept for the whole of their economic life, a residual value based upon the scrap value of steel is acceptable. Therefore the vessels should be depreciated based upon the cost less the scrap value of steel over the 30-year period. The engine need not be componentised as it will have the same 30-year life if maintained every 10 years. It is likely that the cost of major planned maintenance will increase over the life of a vessel due to inflation and the age of the vessel. This additional cost will be capitalised when incurred and therefore the depreciation charge on these components may be greater in the later stages of a vessel's life.

When major planned maintenance work is to be undertaken, the cost should be capitalised. The engine overhaul will be capitalised as a new asset which will then be depreciated over the 10-year period to the next overhaul. The depreciation of the original capitalised amount will typically be calculated such that it had a net book value of nil when the overhaul is undertaken.

This is not the case with one vessel, because work was required earlier than expected. In this case, any remaining net book value of the old engine and overhaul cost should be expensed immediately.

The initial carve out of components should include all major maintenance events which are likely to occur over the economic life of the vessel. Sometimes, it may subsequently be found that the initial allocation was insufficiently detailed, in that not all components were identified. This is the case with the funnels. In this situation it is necessary to determine what the net book value of the component would currently be had it been initially identified. This will sometimes require the initial cost to be determined by reference to the replacement cost and the associated accumulated depreciation charge determined using the rate used for the vessel. This is likely to leave a significant net book value in the component being replaced, which will need to be written off at the time the replacement is capitalised.

50.) Question - LKAS 40 Investment Property / SLFRS 13 Fair Value Measurement

Janne measures its industrial investment property using the fair value method, which is measured using the 'new-build value less obsolescence'. Valuations are conducted by a member of the board of directors. In order to determine the obsolescence, the board member takes account of the age of the property and the nature of its use. According to the board, this method of calculation is complex but gives a very precise result, which is accepted by the industry. There are sales values for similar properties in similar locations available as well as market rent data per square metre for similar industrial buildings. (5 marks)

Required:

Advise Janne on how the above accounting issues should be dealt with in its financial statements.

<u>Answer</u>

Fair value, in LKAS 40 Investment Property, is 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. Fair *value should reflect market conditions at the end of the reporting period. However, SLFRS 13 Fair Value Measurement acts as a common framework on how to measure the fair value when its determination is required or permitted by another SLFRS. The framework defines fair value and provides a single source of guidance for measuring fair value. SLFRS 13 defines the fair value of an asset as an 'exit price', which is 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. Fair value is a market-based measurement, not an entity-specific measurement, and fair value reflects current market conditions.*

In SLFRS 13, fair value measurements are categorised into a three-level hierarchy based on the type of inputs and are not based on a valuation method. The new hierarchy is defined as follows:

(1) Level 1 inputs are unadjusted quoted prices in active markets for items identical to the asset being measured.

(2) Level 2 inputs are inputs other than quoted prices in active markets included within Level 1 that are directly or indirectly observable.

(3) Level 3 inputs are unobservable inputs that are usually determined based on management's assumptions.

Due to the nature of investment property, which is often unique and not traded on a regular basis, and the subsequent lack of observable input data for identical assets, fair value measurements are likely to be categorised as Level 2 or Level 3 valuations. Level 2 inputs are likely to be sale prices per square metre for similar properties in the same location, observable market rents and property yields from the latest transactions. Level 3 inputs may be yields based on management estimates, cash flow forecasts using the entity's own data, and assumptions about the future development of certain parameters such as rental income that are not derived from the market. Management should maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The use of unobservable inputs is a complex and judgemental area where SLFRS 13 provides certain guidance. According to SLFRS 13, there are generally three approaches that can be used to derive fair value: the market approach, the income approach and the cost approach. To measure fair value, management should use valuation techniques consistent with one or more of these approaches. A market or income approach will therefore usually be more appropriate in these circumstances. A valuation based on new-build value less obsolescence takes no account of this consideration. A valuation based on 'new-build value less obsolescence' does not reflect the level 2 inputs which are available, such as sale prices and market rent.

Similarly, the new-build value less obsolescence does not reflect any discounted cash flows based on reliable estimates of future cash flows, or recent prices of similar properties on less active markets and does not take account of any income measures. As level 2 data is available, the entity should use this data in valuing the industrial property.

51.) Question - LKAS 40 Investment Property

Zippy holds properties for investment purposes. At 1 July 2015, Zippy held a 10-floor office block at a fair value of $90 million with a remaining useful life of 15 years. The first floor was occupied by Zippy's staff and the second floor was let to Boo (a subsidiary) free of charge. The other eight floors were all let to unconnected third parties at a normal commercial rent. It was estimated that the fair value of the office block was $96 million at 30 June 2016.

Zippy has a policy of restating all land and buildings to fair value at each reporting date. The only accounting entries for the year ended 30 June 2016 in relation to this office block have been to correctly include the rental income in profit or loss. It can be assumed that each floor is of equal size and value. Depreciation is charged to administrative costs

Discuss the accounting implications on the above

Answer

The first two floors of Zippy's office block should be classified as property, plant and equipment in the consolidated accounts. Owner occupied property cannot be classified as investment property. The second floor is let to Boo, a subsidiary, and is therefore owner occupied from a consolidated accounts perspective. Depreciation should therefore be charged to administrative costs of $1·2 million (($90m x 0·2)/15). A revaluation gain should be recorded within other comprehensive income of $2·4 million (($96m x 0·2) – (($90m x 0·2)) – $1·2m)). The fair value gain relating to the remaining eight floors should be recorded in profit or loss as this would be classified as investment property. A fair value gain to be included in investment income of $4·8 million (($96m x 0·8) – ($90m x 0·8)) arises.

52.) Question - LKAS 40 Investment Property / SLFRS 13 Fair Value Measurement

On 1 March 2014, Canto acquired a property for $15 million, which was used as an office building. Canto measured the property on the cost basis in property, plant and equipment. The useful life of the building was estimated at 30 years from 1 March 2014 with no residual value. Depreciation is charged on the straight-line basis over its useful life. At acquisition, the value of the land content of the property was thought to be immaterial.

During the financial year to 28 February 2017, the planning authorities approved the land to build industrial units and retail outlets on the site. During 2017, Canto ceased using the property as an office and converted the property to an industrial unit. Canto also built retail units on the land during the year to 28 February 2017. At 28 February 2017, Canto wishes to transfer the property at fair value to investment property at $20 million. This valuation was based upon other similar properties owned by Canto. However, if the whole site were sold including the retail outlets, it is estimated that the value of the industrial units would be $25 million because of synergies and complementary cash flows.

The directors of Canto wish to know whether the fair valuation of the investment property is in line with International Financial Reporting Standards and how to account for the change in use of the property in the financial statements at 28 February 2017. (8 marks)

Answer

SLFRS 13 Fair Value Measurement defines fair value as the price which would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by *selling it to another market participant who would use the asset in its highest and best use. The highest and best use of a non-financial asset takes into account the use of the asset which is physically possible, legally permissible and financially feasible. Due to the lack of an active market for identical assets, it would be rare for property to be classified in Level 1 of the fair value hierarchy. In market conditions where property is actively purchased and sold, the fair value measurement might be classified in Level 2. However, that determination will depend on the facts and circumstances, including the significance of adjustments to observable data. In this regard, SLFRS 13 provides a property specific example, stating that a Level 2 input would be the price derived from observed transactions involving similar property interests in similar locations. Accordingly, in active and transparent markets, property valuations may be classified as Level 2, provided that no significant adjustments have been made to the observable data. If significant adjustments to observable data are required, the fair value measurement may fall into Level 3.*

LKAS 40 Investment Property permits entities to choose between a fair value model and a cost model. One method must be adopted for all of an entity's investment property. A change is permitted only if this results in a more appropriate presentation.

LKAS 40 notes that this makes it highly unlikely for a change from a fair value model to a cost model to occur. Transfers to or from investment property should only be made when there is a change in use, which is evidenced by the end of owner-occupation, which has occurred in this case. For a transfer from owner-occupied property to investment property carried at fair value, LKAS 16 Property, Plant and Equipment (PPE) should be applied up to the date of reclassification. Any difference arising between the carrying amount under LKAS 16 at that date and the fair value is dealt with as a revaluation under LKAS 16.

The aggregate fair value of the site, including the industrial and retail outlets, is higher to market participants than the sum of the fair value of the individual property interests because of synergies and complementary cash flows. Consequently, the fair value of the site as a whole would be maximised as a group of assets. The fair value is determined for the whole site even if the asset is disaggregated when applying LKAS 40.

In some cases, it would not be appropriate to estimate fair value of mixed-use property interests as a group. In some instances when valuing property interests, fair value is maximised based on the price which would be received in a current transaction to sell the asset on a stand-alone basis.

Thus providing that the above criteria have been met, Canto may value the property at $25 million. Canto will recognise a depreciation expense of $0·5 million in profit or loss in the year to 28 February 2017 while the property is accounted for using a cost model. At 28 February 2017, Canto will transfer the property from PPE to investment property at its carrying amount of $13·5 million ($15 million – depreciation of $1·5 million) and recognise the increase of $11·5 million in the fair value of the investment property in a revaluation surplus through other comprehensive income and as an increase in the value of the investment property.

53.) Question - LKAS 8 Accounting policies, Changes in accounting estimates and errors

Due to the complexity of International Financial Reporting Standards (SLFRS), often judgements used at the time of transition to SLFRS have resulted in prior period adjustments and changes in estimates being disclosed in financial statements. The selection of accounting policy and estimation techniques is intended to aid comparability and consistency in financial statements. However, SLFRS also place particular emphasis on the need to take into account qualitative characteristics and the use of professional judgement when preparing the financial statements. Although SLFRS may appear prescriptive, the achievement of all the objectives for a set of financial statements will rely on the skills of the preparer. Entities should follow the requirements of LKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors when selecting or changing accounting policies, changing estimation techniques, and correcting errors.

However, the application of LKAS 8 is additionally often dependent upon the application of materiality analysis to identify issues and guide reporting. Entities also often consider the acceptability of the use of hindsight in their reporting.

Required:

(i) Discuss how judgement and materiality play a significant part in the selection of an entity's accounting policies.

(ii) Discuss the circumstances where an entity may change its accounting policies, setting out how a change of accounting policy is applied and the difficulties faced by entities where a change in accounting policy is made.

(iii) Discuss why the current treatment of prior period errors could lead to earnings management by companies, together with any further arguments against the current treatment.

Credit will be given for relevant examples. (15 marks)

<u>Answer</u>

(i) The selection of accounting policy and estimation techniques is intended to aid comparability and consistency in financial statements. Entities should follow the requirements of LKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, when selecting or changing accounting policies, changing estimation techniques, and correcting errors. An entity should determine the accounting policy to be applied to an item with direct reference to SLFRS but accounting policies need not be applied if the effect of applying them would be immaterial. LKAS 8 also notes that it is inappropriate to make or leave uncorrected immaterial departures from SLFRS to achieve a particular position. Where SLFRS does not specifically apply to a transaction, judgement should be used in developing or applying an accounting policy, which results in financial information which is relevant to the decision-making and assessment needs of users. In making that judgement, entities must refer to guidance in SLFRS, which deals with similar issues and then subsequently to definitions, and criteria in the Framework. Additionally, entities can refer to recent pronouncements of other standard setters who use similar conceptual frameworks. Entities should select and apply their accounting policies consistently for similar transactions. If SLFRS specifically permits different accounting policies for categories of similar items, an entity should apply an

appropriate policy for each of the categories in question and apply these accounting policies consistently for each category. For example, for different classes of property, plant and equipment, some may be carried at fair value and some at historical cost.

(ii) A change in accounting policy should only be made if the change is required by SLFRS, or it will result in the financial statements providing reliable and more relevant financial information. Significant changes in accounting policy other than those specified by SLFRS should be relatively rare. SLFRS specifies the accounting policies for a high percentage of the typical transactions which are faced by entities. There are therefore limited opportunities for an entity to choose an accounting policy, as opposed to a basis for estimating figures which will satisfy such a policy. LKAS 8 states that the introduction of an accounting policy to account for transactions where circumstances have changed is not a change in accounting policy. Similarly, an accounting policy for transactions which did not occur previously or which were immaterial is not a change in accounting policy and therefore would be applied prospectively. For example, where an entity changes the use of a property from an administration building to a residential space and therefore an investment property, this would result in a different treatment of revaluation gains and losses. However, this is not a change in accounting policy and so no restatement of comparative amounts should be made. A change in accounting policy is applied retrospectively unless there are transitional arrangements in place. Transitional provisions are often included in new or revised standards and may not require full retrospective application. Sometimes it is difficult to achieve comparability of prior periods with the current period where, for example, data might not have been collected in the prior periods to allow retrospective application. Restating comparative information for prior periods often requires complex and detailed estimation. This, in itself, does not prevent reliable adjustments.

When making estimates for prior periods, the basis of estimation should reflect the circumstances which existed at the time and it becomes increasingly difficult to define those circumstances with the passage of time. Estimate and circumstances might be influenced by knowledge of events and circumstances which have arisen since the prior period. LKAS 8 does not permit the use of hindsight when applying a new accounting policy, either in making assumptions about what management's intentions would have been in a prior period or in estimating amounts to be recognised, measured or disclosed in a prior period.

When it is impracticable to determine the effect of a change in accounting policy on comparative information, the entity is required to apply the new accounting policy to the carrying amounts of the assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable. This could actually be the current period but the entity should attempt to apply the policy from the earliest date possible.

(iii) LKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors requires prior period errors to be amended retrospectively by restating the comparatives as if the error had never occurred. Hence, the impact of any prior period errors is shown through retained earnings rather than being included in the current period's profit or loss. Managers could use this treatment for prior period errors as a method for manipulating current period earnings. Restatements due to errors and irregularities can be considered to indicate poor earnings quality, and to threaten investor confidence, particularly if they occur frequently. Thus, it might appear that the factors associated with earnings corrections could be linked to earnings management. Arguments against the approach in LKAS 8 are:

– that the standard allows inappropriate use of hindsight;

– that the treatment renders errors less prominent to users; and

– that it allows amounts to be debited or credited to retained profits without ever being included in a current period profit or loss.

Managers have considerable discretion regarding the degree of attention drawn to such changes. The information content and prominence to users of disclosures regarding prior period errors are issues of significance, with potential economic and earnings quality implications. Expenses could be moved backward into a prior period, with the result that managers are given a possible alternative strategy with which to manage earnings. It is possible to misclassify liabilities, for example, as non-current rather than current, or even simply miscalculate reported earnings per share. Under LKAS 8, the prior period error can then be amended the following year, with no lingering effects on the statement of financial position as a result of the manipulation.

54.) Question - LKAS 23 Borrowing Costs / LKAS 8 Accounting policies, Changes in accounting estimates and errors

In 2013, Zack, a public limited company, commenced construction of a shopping centre. It considers that in order to fairly recognise the costs of its property, plant and equipment, it needs to enhance its accounting policies by capitalising borrowing costs incurred whilst the shopping centre is under construction. A review of past transactions suggests that there has been one other project involving assets with substantial construction periods where there would be a material misstatement of the asset balance if borrowing costs were not capitalised. This project was completed in the year ended 30 November 2012. Previously, Zack had expensed the borrowing costs as they were incurred. The borrowing costs which could be capitalised are \$2 million for the 2012 asset and \$3 million for the 2013 asset.

A review of the depreciation schedules of the larger plant and equipment not affected by the above has resulted in Zack concluding that the basis on which these assets are depreciated would better reflect the resources consumed if calculations were on a reducing balance basis, rather than a straight-line basis. The revision would result in an increase in depreciation for the year to 30 November 2012 of \$5 million, an increase for the year end 30 November 2013 of \$6 million and an estimated increase for the year ending 30 November 2014 of \$8 million.

Additionally, Zack has discovered that its accruals systems for year-end creditors for the financial year 30 November 2012 processed certain accruals twice in the ledger. This meant that expenditure services were overstated in the financial statements by \$2 million. However, Zack has since reviewed its final accounts systems and processes and has made appropriate changes and introduced additional internal controls to ensure that such estimation problems are unlikely to recur.

All of the above transactions are material to Zack.

Required:

Discuss how the above events should be shown in the financial statements of Zack for the year ended 30 November 2013. (8 marks)

Answer

LKAS 23 Borrowing Costs states that such costs which are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset and, therefore, should be capitalised. Other borrowing costs are recognized as an expense. Thus the change in accounting policy actually only brings Zack in line with SLFRS, with the result that there is an accounting error which will require a prior period adjustment. In applying the new accounting policy, Zack has identified that there is another asset where there is a material impact if borrowing costs should have been capitalised during the construction period. This contract was completed during 2012. Thus, the financial statements for the year ended 30 November 2012 should be restated to apply the new policy to this asset. The effects of the restatement are as follows: at 30 November 2012, the carrying amount of property, plant and equipment is restated upwards by $2 million less depreciation for the period and this would result in an increase in profit or loss for the period of the same amount. Disclosures relating to prior period errors include: the nature of the prior period error for each prior period presented, to the extent practicable; the amount of the correction for each financial statement line item affected; and for basic and diluted earnings per share, the amount of the correction at the beginning of the earliest prior period presented. The disclosure would include the nature of the prior period error.

The line items in the statement of profit or loss and other comprehensive income would also change. For the current period, Zack would disclose the impact of the prior period error of $3 million. It can be assumed that, because the asset is under construction, there will be no depreciation on the asset.

The change in the depreciation method is not a change in an accounting policy but a change in an accounting estimate. For changes in accounting estimates, Zack should disclose the nature and the amount of the change which affects the current period or which it is expected to have in future periods. It should be noted that LKAS 8 does permit an exception where it is impracticable to estimate the effect on future periods. Where the effect on future periods is not disclosed because it is impracticable, that fact should be disclosed. The revision results in an increase in depreciation for 2013 of $6m and the disclosure of an estimated increase for 2014 of $8m.

The systems error has resulted in a prior period error. In order to correct this error, Zack should restate the prior year information for the year ended 30 November 2012 for the $2m in the statement of profit or loss and other comprehensive income. Additionally, the trade creditors figure in the statement of financial position is overstated by $2 million and should be restated. The movement in reserves note will also require restating. This is not a correction of an accounting estimate.

55.) Question - LKAS 38 Intangible Assets

On 1 December 2012, Suntory acquired a trademark, Golfo, for a line of golf clothing for $3 million. Initially, Suntory expected to continue marketing and receiving cash flows from the Golfo product-line indefinitely.

However, because of the difficulty in determining its useful life, Suntory decided to amortise the trademark over a 10-year life, using the straight-line method. In December 2015, a competitor unexpectedly revealed a technological breakthrough which is expected to result in a product which, when launched, will significantly reduce the demand for the Golfo product-line. The demand for the Golfo product-line is expected to remain high until May 2018, when the competitor is expected to launch its new product.

At 30 November 2016, the end of the financial year, Suntory assessed the recoverable amount of the trademark at $500,000 and intends to continue manufacturing Golfo products until 31 May 2018.

The directors of Suntory require advice as to how to deal with the trademark in the financial statements for the year ended 30 November 2016. (7 marks)

Answer

LKAS 38 Intangible Assets states that the cost less residual value of an intangible asset with a finite useful life should be amortised on a systematic basis over that life, that the amortisation method should reflect the pattern of benefits and that it should be reviewed at least annually.

The amortisation method should be reviewed at least annually and, if the pattern of consumption of benefits has changed, the amortisation method should be changed prospectively as a change in estimate under LKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. Expected future reductions in sales could be indicative of a higher rate of consumption of the future economic benefits embodied in an asset. Hence, the trademark would be amortised over a 2·5-year period until May 2018.

LKAS 36 states that an entity should assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity should estimate the recoverable amount of the asset. Irrespective of whether there is any indication of impairment, an entity shall also test an intangible asset with an indefinite useful life or an intangible asset not yet available for use for impairment annually by comparing its carrying amount with its recoverable amount. This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year. Thus, Suntory should test the trademark for impairment.

For the year ended 30 November 2016

Dr Profit or loss (operating expenses) – amortisation of trademark $840,000

Cr Intangible asset (trademark) – accumulated amortisation $840,000

To recognise the annual amortisation of the trademark during the period.

At 30 November 2016

Dr Profit or loss (operating expenses) – impairment of trademark $760,000

Cr Intangible asset (finite life trademark) – impairment $760,000

To recognise the impairment loss for the trademark.

Workings

Cost of trademark \$3m ÷ 10 years useful life = \$300,000 amortisation per year. Therefore the carrying amount at 1 December 2015 is (\$3m cost less (\$300,000 amortisation per year x 3 years since acquisition)) = \$2·1m.

The useful life of the trademark is reduced to 2·5 years and therefore this amount has to be amortised over this period.

\$2·1 m ÷ 2·5 years remaining useful life = \$840,000 per year

Therefore the carrying amount at 30 November 2016 is \$3m cost less \$900,000 less \$840,000 = \$1·26 million. The recoverable amount is \$500,000, so the impairment loss is \$760,000

56.) Question - LKAS 38 Intangible Assets

Darlatt has built an offshore wind farm with the purpose of testing the efficiency of its prototype wind turbines. Darlatt has applied to the regulators for approval for production of its new prototype but has only received permission to test the prototype wind turbine. The wind farm development will enable Darlatt to test the reliability of the new wind turbines which should assist in developing more efficient and cost effective offshore wind turbines but as yet, there has not been any commercial production of the prototype wind turbines as there is still some slight doubt over the wind turbine's durability in extreme weather conditions. The renewable energy generated during the testing phase of the wind turbines is sold to the national regulator of electricity. There is sufficient resource to complete the wind farm project but the energy income has not been included in management's resource planning.

The directors of Darlatt wish to know how the expenditure on the wind farm and the income from the sale of energy should be treated in the financial statements. (8 marks)

Answer

Development is defined in LKAS 38 Intangible Assets as the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use. Commercial production is not defined in LKAS 38 but it would suggest that it includes an approved technology or any output from its use being available for sale to customers. The wind farm is essentially a test site to create knowledge about the design of future wind turbines to create a more efficient and cost effective product. There has not been commercial production of the wind turbine because of doubts over its durability and therefore the designation of the farm as a development project should remain until the technology has been proven. Once commercial production commences, then the development phase is complete.

During the development phase, these costs should be treated as intangible assets if they meet the capitalisation requirements in LKAS 38. These requirements include its technical feasibility for use or sale, the entity's intention to complete the intangible asset and use or sell it, the generation of probable future economic benefits, the availability of adequate resources to complete the development and the entity's ability to measure reliably the expenditure on the development. However, judgement should be used to determine whether these assets should be recorded as property, plant and equipment as they are actually producing energy.

A further question is whether the income generated from the wind farm should be offset against the development cost or recognised in profit or loss. The income from the sale of energy is essentially a by-product of the development and is not necessary to develop the assets for their intended use. Therefore the income should be shown as operating income. There are differing views on whether offsetting provides decision useful information and is appropriate under the Conceptual Framework.

It is felt that offsetting is not in line with the Conceptual Framework and in this case is not appropriate due to the different nature of the income from the expense items.

57.) Question - LKAS 37 Provisions, Contingent Liabilities and Contingent Assets

In February 2012, an inter-city train did what appeared to be superficial damage to a storage facility of a local company. The directors of the company expressed an intention to sue Verge but in the absence of legal proceedings, Verge had not recognised a provision in its financial statements to 31 March 2012. In July 2012, Verge received notification for damages of $1·2m, which was based upon the estimated cost to repair the building. The local company claimed the building was much more than a storage facility as it as a valuable piece of architecture which had been damaged to a greater extent than was originally thought. The head of legal services advised Verge that the company was clearly negligent but the view obtained from an expert was that the value of the building was $800,000. Verge had an insurance policy that would cover the first $200,000 of such claims. After the financial statements for the year ended 31 March 2013 were authorised, the case came to court and the judge determined that the storage facility actually was a valuable piece of architecture. The court ruled that Verge was negligent and awarded $300,000 for the damage to the fabric of the facility.

Required:

Advise Verge on how the above accounting issues should be dealt with in its financial statements for the years ending 31 March 2012 (where applicable) and 31 March 2013. (6 marks)

<u>Answer</u>

Under LKAS 37 Provisions, Contingent Liabilities and Contingent Assets, an entity must recognise a provision if, and only if:

– a present obligation (legal or constructive) has arisen as a result of a past event (the obligating event),

– payment is probable ('more likely than not'), and

– the amount can be estimated reliably.

An obligating event is an event that creates a legal or constructive obligation and, therefore, results in an entity having no realistic alternative but to settle the obligation. The obligating event took place in the year to 31 March 2012. A provision should be made on the date of the obligating event, which is the date on which the event takes place that results in an entity having no realistic alternative to settling the legal or constructive obligation. Even in the absence of legal proceedings, Verge should prudently recognise an obligation to pay damages, but it is reasonable at 31 March 2012 to assess the need for a provision to *be immaterial as no legal proceedings have been started and the damage to the building seemed superficial.*

Provisions should represent the best estimate at the financial statement date of the expenditure required to settle the present obligation and this measurement should take into account the risks and uncertainties of circumstances relevant to the obligation.

In the year to 31 March 2013, as a result of the legal arguments supporting the action, Verge will have to reassess its estimate of the likely damages and a provision is needed, based on the advice that it has regarding the likely settlement. Provisions should be reviewed at each year end for material changes to the best estimate.

Dr Profit or loss $800,000

Cr Provision for damages $800,000

The potential for reimbursements (e.g. insurance payments) to cover some of the expenditure required to settle a provision can be recognised, but only if receipt is virtually certain if the entity settles the obligation. LKAS 37 requires that the reimbursement be treated as a separate asset. The amount recognised for the reimbursement cannot exceed the amount of the provision. LKAS 37 permits the expense relating to a provision to be presented net of the amount. The company seems confident that it will satisfy the terms of the insurance policy and should accrue for the reimbursement:

Dr Trade receivables $200,000

Cr Profit or loss $200,000

The court case was found against Verge but as this was after the authorisation of the financial statements, there is no adjustment of the provision at 31 March 2013. It is not an adjusting event.