Practice Questions

Question 1

Orange Co is the parent company of a group undergoing rapid expansion through acquisition. Orange Co has a subsidiary Honey Co. The current financial year end is 31 March 2018.

Acquisition of Honey Co

Orange Co acquired 80% of the five million equity shares (Rs.1 each) of Honey Co on 1 April 2014 for cash of Rs.90 million. The fair value of the non-controlling interest (NCI) at acquisition was Rs.22 million. The fair value of the identifiable net assets at acquisition was Rs.65 million, excluding the following asset.

Honey Co purchased a factory site several years prior to the date of acquisition. Land and property prices in the area had increased significantly in the years immediately prior to 1 April 2014. Nearby sites had been acquired and converted into residential use. It is felt that, should the Honey Co site also be converted into residential use, the factory site would have a market value of Rs.24 million. Rs.1 million of costs are estimated to be required to demolish the factory and to obtain planning permission for the conversion. Honey Co was not intending to convert the site at the acquisition date and had not sought planning permission at that date. The depreciated replacement cost of the factory at 1 April 2014 has been correctly calculated as Rs.17·4 million.

Impairment of Honey Co

Honey Co incurred losses during the year ended 31 March 2018 and an impairment review was performed. The recoverable amount of Honey Co's assets was estimated to be Rs.100 million. Included in this assessment was the only building owned by Honey Co which had been damaged in a storm and impaired to the extent of Rs.4 million. The carrying amount of the net assets of Honey Co at 31 March 2018 (including fair value adjustments on acquisition but excluding goodwill) are as follows:

	Rs. millions
Land and buildings	60
Other plant and machinery	15
Intangibles other than goodwill	9
Current assets (recoverable amount)	22
Total	106

None of the assets of Honey Co including goodwill have been impaired previously. Honey Co does not have a policy of revaluing its assets.

Required:

Draft an explanatory note to the directors of Orange Co, addressing the following:

(a) (i) How the fair value of the factory site should be determined at 1 April 2014 and why the depreciated replacement cost of Rs.17·4 million is unlikely to be a reasonable estimate of fair value. (7 marks)

(ii) A calculation of goodwill arising on the acquisition of Honey Co measuring the non-controlling interest at:

– fair value;

– proportionate share of the net assets. (3 marks)

(b) Discuss the calculation and allocation of Honey Co's impairment loss at 31 March 2018 and why the impairment loss of Honey Co would differ depending on how non-controlling interests are measured. Your answer should include a calculation and an explanation of how the impairments would impact upon the consolidated financial statements of Orange Co. (11 marks)

Answer

(a) (i)

SLFRS 13 Fair Value Measurement permits a range of valuation methods to estimate fair value including market based, income estimates and a cost-based approach. However, the characteristics of each asset should be considered when determining the most appropriate methodology.

Fair value is defined 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. Fair value is therefore not supposed to be entity specific but rather to be market focused. The estimate consequently should consider what the market would be prepared to pay for the asset.

The market would consider all alternative uses for the assessment of the price which they would be willing to pay. Fair value should therefore be measured by consideration of the highest and best use of the asset. There is a presumption that the current use would be the highest and best use.

The highest and best use of the asset would appear to be as residential property and not the current industrial use. The intentions of Honey Co are not relevant as fair value is not entity specific. The alternative use would need to be based upon fair and reasonable assumptions. In particular, it would be necessary to ensure that planning permission to demolish the factory and convert into residential properties would be likely. Since several nearby sites have been given such permission, this would appear to be the case.

The fair value of the factory site should be valued as if converted into residential use. Since this cannot be determined on a stand-alone basis, the combined value of the land and buildings is calculated. The Rs.1 million demolition and planning costs should be deducted from the market value of Rs.24 million. The fair value of the land and buildings should be Rs.23 million. The fair value of the identifiable net assets at acquisition are Rs.88 million (Rs.65m + Rs.23m).

Depreciated replacement cost should only be considered as a possible method for estimating the fair value of the asset when other more suitable methods are not available. This may be the case when the asset is highly specialised and market data is therefore limited or unavailable. This is not the case with the factory site. In any case, the rise in value of land and properties particularly for residential use would mean that to use depreciated replacement cost would undervalue the asset. The exit value for the asset, whether it was based on the principal or most advantageous market, would need to be the same as the entry price. Depreciation may not also be an accurate reflection of all forms of obsolescence including physical deterioration. The estimate would need to be adjusted for such factors even where industrial use remained the best use of the asset.

(ii)

Goodwill should be calculated as follows:

	Fair value method	Proportionate method
	Rs. millions	Rs. millions
Consideration	90	90
Non-controlling interest (NCI) at acquisition	22	17·6
Net assets at acquisition	(88)	(88)
Goodwill	24	19·6

NCI at acquisition under proportional method is Rs.17·6m (20% x Rs.88m).

The fair value of the net assets at acquisition is Rs.88m as per part a(i) (Rs.65m + Rs.23m).

Goodwill under the proportional method could also be calculated as:

Consideration	Rs.90m
Less FV of net assets acquired (80% x Rs.88m)	(Rs.70·4)m
Goodwill on acquisition	Rs.19·6m

(b)

An impairment arises where the carrying amount of the net assets exceeds the recoverable amount. Where there is a clear indication of impairment, this asset should be reduced to the recoverable amount.

Where the cash flows cannot be independently determined for individual assets, they should be assessed as a cash generating unit. That is the smallest group of assets which independently generate cash flows. Impairments of cash generating units are allocated first to goodwill and then pro rata on the other assets. It should be noted that no asset should be reduced below its recoverable amount.

Fair value method

The overall impairment of Honey Co is Rs.30 million (Rs.106m + goodwill Rs.24m – Rs.100m). The damaged building should be impaired by Rs.4 million with a corresponding charge to profit or loss. Since Rs.4 million has already been allocated to the land and buildings, Rs.26 million remains. The goodwill should therefore be written off and expensed in the consolidated statement of profit or loss.

Of the remaining Rs.2 million, Rs.1·25 million will be allocated to the plant and machinery (15/(15 + 9) x 2m) and Rs.0·75 million will be allocated to the remaining intangibles (9/(9 + 15) x 2m). As no assets have been previously revalued, all the impairments are charged to profit or loss. Rs.24 million (80% x Rs.30m) will be attributable to the owners of Orange Co and Rs.6 million to the NCI in the consolidated statement of comprehensive income.

The allocation of the impairment is summarised in this table:

	Original value	Impairment	Revised CV
	Rs.m	Rs.m	Rs.m
Land and buildings	60	4	56
Plant and machinery	15	1·25	13·75
Intangibles other than goodwill	9	0·75	8·25
Goodwill	24	24	0
Current assets (at recoverable amount)	22	0	22
Total	130	30	100

Proportionate method

The basic principles and rule for impairment is the same as the fair value method and so Rs.4 million will again first be written off against the land and buildings. The problems arise when performing the impairment review as a cash generating unit. When NCI is measured using the proportional share of net assets, no goodwill is attributable to the NCI since goodwill is not included within the individual net assets of the subsidiary. This means that the goodwill needs to be grossed up when an impairment review is performed so that it is comparable with the recoverable amount. Under the fair value method, the NCI fully represents any premium the other shareholders would be prepared to pay for the net assets and so goodwill does not need to be grossed up.

The goodwill of Rs.19·6 million is grossed up by 100/80 to a value of Rs.24·5 million. This extra Rs.4·9 million is known as notional goodwill. The overall impairment is now Rs.30·5 million (Rs.106m + Rs.24·5m – Rs.100m) of which Rs.4 million has already been allocated. Since the remaining impairment of Rs.26·5 million exceeds the value of goodwill, the goodwill is written down to zero. However, as only Rs.19·6 million goodwill is recognised within the consolidated accounts, the impairment attributable to the notional goodwill is not recognised. Only Rs.19·6 million is deducted in full from the owners of Orange Co's share of profits since there is no goodwill attributable to the non-controlling interest. The remaining Rs.2 million impairment is allocated between plant and machinery and intangibles (other than goodwill). NCI will be allocated 20% of Rs.6m (Rs.4m + Rs.2m), i.e. Rs.1·2 million.

Consolidated retained earnings will be charged with 80% of Rs.6m (i.e. Rs.4·8m) plus Rs.19·6 million goodwill impairment (i.e. Rs.24·4m in total). The allocation of the impairment is summarised in this table:

	Original Carrying amount	Impairment	Revised carrying amount
	Rs'mn	Rs'mn	Rs'mn
Land and buildings	60	4	56
Plant and machinery	15	1·25	13·75
Intangibles other than goodwill	9	0·75	8·25
Goodwill	19·6	19·6	0
(Notional goodwill)	4·9	4·9	0
Current assets (at recoverable amount)	22		22
Total	130·5	30·5	100

Question 2

Banana is the parent of a listed group of companies which have a year end of 30 June 2017. Banana has made a number of acquisitions and disposals of investments during the current financial year and the directors require advice as to the correct accounting treatment of these acquisitions and disposals.

The acquisition of Grape

On 1 January 2017, Banana acquired an 80% equity interest in Grape. The following is a summary of Grape's equity at the acquisition date.

	Rs'mn
Equity share capital (Rs.1 per share)	20
Retained earnings	42
Other equity components	8
Total	**70**

The purchase consideration comprised 10 million of Banana's shares which had a nominal value of Rs.1 each and a market price of Rs.6·80 each. Additionally, cash of Rs.18 million was due to be paid on 1 January 2019 if the net profit after tax of Grape grew by 5% in each of the two years following acquisition. The present value of the total contingent consideration at 1 January 2017 was Rs.16 million. It was felt that there was a 25% chance of the profit target being met. At acquisition, the only adjustment required to the identifiable net assets of Grape was for land which had a fair value Rs.5 million higher than its carrying amount. This is not included within the Rs.70 million equity of Grape at 1 January 2017.

Goodwill for the consolidated financial statements has been incorrectly calculated as follows:

	Rs'mn
Share consideration	68
Add : NCI at acquisition (20% x Rs.70mn)	14
Less : Net assets at acquisition	(70)
Goodwill at acquisition	**12**

The financial director did not take into account the contingent cash since it was not probable that it would be paid. Additionally, he measured the non-controlling interest using the proportional method of net assets despite the group having a published policy to measure non-controlling interest at fair value. The share price of Grape at acquisition was Rs.4·25 and should be used to value the non-controlling interest.

The acquisition and subsequent disposal of Strawberry

Banana had purchased a 40% equity interest in Strawberry for Rs.18 million a number of years ago when the fair value of the identifiable net assets was Rs.44 million. Since acquisition, Banana had the right to appoint one of the five directors on the board of Strawberry. The investment has always been equity accounted for in the consolidated financial statements of Banana. Banana disposed of 75% of its 40% investment on 1 October 2016 for Rs.19 million when the fair values of the identifiable net assets of Strawberry were Rs.50 million. At that date, Banana lost its right to appoint one director to the board. The fair value of the remaining 10% equity interest was Rs.4·5 million at disposal but only Rs.4 million at 30 June 2017. Banana has recorded a loss in reserves of Rs.14 million calculated as the difference between the price paid of Rs.18 million and the fair value of Rs.4 million at the reporting date. Banana has stated that they have no intention to sell their remaining shares in Strawberry and wish to classify the remaining 10% interest as fair value through other comprehensive income in accordance with SLFRS 9 Financial Instruments.

The acquisition of Melon

On 30 June 2017, Banana acquired all of the shares of Melon, an entity which operates in the biotechnology industry.

Melon was only recently formed and its only asset consists of a licence to carry out research activities. Melon has no employees as research activities were outsourced to other companies. The activities are still at a very early stage and it is not clear that any definitive product would result from the activities. A management company provides personnel for Melon to supply supervisory activities and administrative functions. Banana believes that Melon does not constitute a business in accordance with SLFRS 3 Business Combinations since it does not have employees nor carries out any of its own processes. Banana intends to employ its own staff to operate Melon rather than to continue to use the services of the management company. The directors of Banana therefore believe that Melon should be treated as an asset acquisition.

Required:

(a) Draft an explanatory note to the directors of Banana, discussing the following:

(i) how goodwill should have been calculated on the acquisition of Grape and show the accounting entry which is required to amend the financial director's error; (8 marks)

(ii) why equity accounting was the appropriate treatment for Strawberry in the consolidated financial statements up to the date of its disposal showing the carrying amount of the investment in Strawberry just prior to disposal; (4 marks)

(iii) how the gain or loss on disposal of Strawberry should have been recorded in the consolidated financial statements and how the investment in Strawberry should be accounted for after the part disposal. (4 marks)

(b) Discuss whether the directors are correct to treat Melon as a financial asset acquisition and whether the International Accounting Standards Board's proposed amendments to the definition of a business would revise your conclusions.

Answer

(a)

Explanatory note to: Directors of Banana

Subject: Consolidation of Grape and Strawberry

(i) Goodwill should be calculated by comparing the fair value of the consideration with the fair value of the identifiable net assets at acquisition. The shares have been correctly valued using the market price of Banana at acquisition. Contingent consideration should be included at its fair value which should be assessed taking into account the probability of the targets being achieved as well as being discounted to present value. It would appear reasonable to measure the consideration at a value of Rs.4 million (Rs.16 million x 25%). A corresponding liability should be included within the consolidated financial statements with subsequent remeasurement. This would be adjusted prospectively to profit or loss rather than adjusting the consideration and goodwill.

The finance director has erroneously measured non-controlling interest using the proportional method rather than at fair value. Although either method is permitted on an acquisition by acquisition basis, the accounting policy of the Banana group is to measure non-controlling interest at fair value. The fair value of the non-controlling interest at acquisition is (20% x Rs.20 million x Rs.4·25) = Rs.17 million.

Net assets at acquisition were incorrectly included at their carrying amount of Rs.70 million. This should be adjusted to fair value of Rs.75 million with a corresponding Rs.5 million increase to land in the consolidated statement of financial position.

Goodwill should have been calculated as follows:	Rs. million
Fair value of share exchange	68
Contingent consideration	4
Non-controlling interest at acquisition	17
Fair value of identifiable net assets acquired	(75)
	–––
Goodwill	14
	–––

The correcting entry required to the consolidated financial statements is:

Dr Goodwill	Rs.2 million
Dr Land	Rs.5 million
Cr Non-controlling interest	Rs.3 million
Cr Liabilities	Rs.4 million

(ii) If an entity holds 20% or more of the voting power of the investee, it is presumed that the entity has significant influence unless it can be clearly demonstrated that this is not the case. The existence of significant influence by an entity is usually evidenced by representation on the board of directors or participation in key policy making processes. Banana has 40% of the equity of Strawberry and can appoint one director to the board. It would appear that Banana has significant influence but not control. Strawberry should be classified as an associate and be equity accounted for within the consolidated financial statements.

The equity method is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income. At 1 October 2017, Strawberry should have been included in the consolidated financial statements at a value of Rs.20·4 million (Rs.18 million + 40% x Rs.50 million – Rs.44 million).

(iii) On disposal of 75% of the shares, Banana no longer exercises significant influence over Strawberry and a profit on disposal of Rs.3·1 million should have been calculated.

	Rs. million
Proceeds	19
Fair value of retained interest	4·5
Carrying amount of investment in associate (see part (ii))	(20·4)
	——
Gain on disposal	3·1
	——

Banana is incorrect to have recorded a loss in reserves of Rs.14 million and this should be reversed. Instead, a gain of Rs.3·1 million should have been included within the consolidated statement of profit or loss. The investment is initially restated to fair value of Rs.4·5 million. Banana does not intend to sell their remaining interest and providing that they make an irrecoverable election, they can treat the remaining interest at fair value through other comprehensive income. The investment will be restated to Rs.4 million at the reporting date with a corresponding loss of Rs.0·5 million reported in other comprehensive income.

(b) Melon should only be treated as an asset acquisition where the acquisition fails the definition of a business combination. In accordance with SLFRS 3 Business Combinations, 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 are 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 will typically have inputs and processes applied to the ability to create outputs. Outputs are the result of inputs and processes and are usually present within a business but are not a necessary requirement for a set of integrated activities and assets to be defined as a business at acquisition.

It is clear that Melon has both inputs and processes. The licence is an input as it is an economic resource within the control of Melon which is capable of providing outputs once one or more processes are applied to it. Additionally, the seller does not have to be operating the activities as a business for the acquisition to be classified as a business. It is not relevant therefore that Melon does not have staff and outsources its activities. The definition of a business requires just that the activities could have been operated as a business. Processes are in place through the research activities, integration with the management company and supervisory and administrative functions performed. The research activities are still at an early stage, so no output is yet obtainable but, as identified, this is not a necessary prerequisite for the acquisition to be treated as a business. It can be concluded that Melon is a business and it is incorrect to treat Melon as an asset acquisition.

Question 3

Carbise is the parent company of an international group which has a presentation and functional currency of the Rupees. The group operates within the manufacturing sector. On 1 January 2012, Carbise acquired 80% of the equity share capital of Bikelite, an overseas subsidiary. The acquisition enabled Carbise to access new international markets.

Carbise transfers surplus work-in-progress to Bikelite which is then completed and sold in various locations. The acquisition was not as successful as anticipated and on 30 September 2016 Carbise disposed of all of its holding in Bikelite. The current year end is 31 December 2016.

Bikelite trading information

Bikelite is based overseas where the domestic currency is the shillings. Staff costs and overhead expenses are all paid in shillings. However, Bikelite also has a range of transactions in a number of other currencies. Approximately 40% of its raw material purchases are in shillings and 50% in the yen. The remaining 10% are in Rupees of which approximately half were purchases of material from Carbise. This ratio continued even after Carbise disposed of its shares in Bikelite. Revenue is invoiced in equal proportion between shillings, yen and Rupees. To protect itself from exchange rate risk, Bikelite retains cash in all three currencies. No dividends have been paid by Bikelite for several years. At the start of 2016 Bikelite sought additional debt finance. As Carbise was already looking to divest, funds were raised from an issue of bonds in shillings, none of which were acquired by Carbise.

Acquisition of Bikelite

Carbise paid shillings 100 million for 80% of the ordinary share capital of Bikelite on 1 January 2012. The net assets of Bikelite at this date had a carrying amount of shillings 60 million. The only fair value adjustment deemed necessary was in relation to a building which had a fair value of shillings 20 million above its carrying amount and a remaining useful life of 20 years at the acquisition date. Carbise measures non-controlling interests (NCI) at fair value for all acquisitions, and the fair value of the 20% interest was estimated to be shillings 22 million at acquisition. Due to the relatively poor performance of Bikelite, it was decided to impair goodwill by shillings 6 million during the year ending 31 December 2015.

Rates of exchange between the Rs and shillings are given as follows:

1 January 2012	Rs.1 : 0·5 shillings
Average rate for year ended 31 December 2015	Rs.1 : 0·4 shillings
31 December 2015:	Rs.1 : 0·38 shillings
30 September 2016:	Rs.1 : 0·35 shillings
Average rate for the nine-month period ended 30 September 2016	Rs.1 : 0·37 shillings

Disposal of Bikelite

Carbise sold its entire equity shareholding in Bikelite on 30 September 2016 for Rs.150 million. Further details relating to the disposal are as follows:

Carrying amount of Bikelite's net assets at 1 January 2016	shillings 48 million
Bikelite loss for the year ended 31 December 2016	shillings 8 million
Cumulative exchange gains on Bikelite at 1 January 2016	Rs.74·1 million
Non-controlling interest in Bikelite at 1 January 2016	Rs.47·8 million

Required:

(a) Prepare an explanatory note for the directors of Carbise which addresses the following issues:

(i) What is meant by an entity's presentation and functional currency. Explain your answer with reference to how the presentation and functional currency of Bikelite should be determined. (7 marks)

(ii) A calculation of the goodwill on the acquisition of Bikelite and what the balance would be at 30 September 2016 immediately before the disposal of the shares. Your answer should include a calculation of the exchange difference on goodwill for the period from 1 January 2016 to 30 September 2016. (5 marks)

(iii) An explanation of your calculation of goodwill and the treatment of exchange differences on goodwill in the consolidated financial statements. You do not need to discuss how the disposal will affect the exchange differences. (4 marks)

Note: Any workings can either be shown in the main body of the explanatory note or in an appendix to the explanatory note.

(b) Explain why exchange differences will arise on the net assets and profit or loss of Bikelite each year and how they would be presented within the consolidated financial statements. Your answer should include a calculation of the exchange differences which would arise on the translation of Bikelite (excluding goodwill) in the year ended 31 December 2016. (7 marks)

(c)

(i) Calculate the group profit or loss on the disposal of Bikelite. (3 marks)

(ii) Briefly explain how Bikelite should be treated and presented in the consolidated financial statements of Carbise for the year ended 31 December 2016. (4 marks)

Answer

(a) Explanatory note to: Directors of Carbise

Subject: Foreign subsidiary Bikelite

(i) The presentation currency is the currency in which the financial statements are presented. LKAS 21 The Effects of Changes in Foreign Exchange Rates permits an entity to present its individual financial statements in any currency. It would therefore be up to the directors of Bikelite to choose a presentation currency for its individual financial statements.

Factors which could be considered include the currency used by major shareholders and the currency in which debt finance is primarily raised. The functional currency is the currency of the primary economic environment in which the entity operates. Since transactions are initially recorded in an entity's functional currency, the results and financial position would need to be retranslated where this differed to the presentation currency.

When determining the presentation and functional currency of Bikelite, consideration should first be given to whether the functional currency of Bikelite should be the same as Carbise, at least whilst under the control of Carbise. It appears that Bikelite has considerable autonomy over its activities. Despite being acquired to make more efficient use of the surplus inventory of Carbise, purchases from Carbise were only 5% of Bikelite's total purchases. Revenue is invoiced in a range of currencies suggesting a geographically diverse range of customers which, although this allows Carbise access to new international markets, is unlikely to be classified as an extension of the parent's operations. The volume of the transactions involved between Carbise and Bikelite would seem to be far too low to come to this conclusion. Bikelite also appears free to retain cash in a range of currencies and is not obliged to remit the cash to Carbise in the form of dividends. Nor does Bikelite appear to be dependent on financing from Carbise with other investors taking up the bond issue at the start of 2016. The functional currency of Bikelite does not need to be the same as Carbise.

In choosing its functional currency, Bikelite should consider the following primary factors: the currency which mainly influences the sales price for their goods, the currency of the country whose competitive forces and regulations determine the sales price and also the currency which influences labour, material and overhead costs. The key determinant here is the currency which the majority of the transactions are settled in. Bikelite invoices and is invoiced in a large range of currencies and so it would not be immediately clear as to the appropriate functional currency. Nor is there detail about whether there is a currency in which competitive forces and regulations could be important. We do not know, for example, what currency Bikelite's major competitors invoice in.

Secondary factors including the currency in which financing activities are obtained and the currency in which receipts from operating activities are retained can help guide the entity where it is not immediately clear. In relation to Bikelite, a significant volume of their sales are invoiced in shillingss and the majority of their expenses too, given that wages and overheads are also paid in shillingss. Funds were raised in shillings from the bond issue and so it would appear that the shillings should probably be the functional currency for Bikelite. It is also possible that Bikelite may lose their autonomy on Carbise's sale of their shares which could have implications for the determination of the functional currency.

(ii) Goodwill in shillings on the acquisition of Bikelite would be shillings 42 million calculated as follows:

	Shillings millions
Consideration	100
FV of NCI	22
Less net assets at acquisition (60 + 20)	(80)
	——
Goodwill at acquisition	42
	——

On acquisition, the goodwill in Rs. would be (shillings 42m/0·5) Rs.84 million.

Goodwill at 30 September 2016 would be:

	Shillings millions	rate	Rs. millions
Goodwill at 1 January 2012	42	0·5	84
Impairment y/e 31 December 2015	(6)	0·4	(15)
Exchange gain			25·7 (bal)
	–––		–––––
Goodwill at 31 December 2015	36	0·38	94·7
Current year exchange gain			8·2 (bal)
	–––		–––––
Goodwill at 30 September 2016	36	0·35	102·9
	–––		–––––

Workings

Shillings impairment of 6 million is translated at the average rate of Rs.1:0·4 shillings = Rs.15 million.

Goodwill at 31 December 2015 would be translated at last year's closing rate of Rs.1:0·38 shillings = Rs.94·7m.

Goodwill at 31 September 2016 will be translated at Rs.1:0·35 shillings = Rs.102·9m.

(iii) On a business combination, goodwill is calculated by comparing the fair value of the consideration plus non-controlling interests (NCI) at acquisition with the fair value of the identifiable net assets at acquisition. Carbise measures NCI using the fair value method. This means that goodwill attributable to the NCI is included within the overall calculation of goodwill. An adjustment of shillings 20 million is required to the property of Bikelite to ensure the net assets at acquisition are properly included at their fair value.

At each year end, all assets (and liabilities) are retranslated using the closing rate of exchange. Exchange differences arising on the retranslation are recorded within equity. Since the non-controlling interest is measured under the fair value method, the exchange difference would be apportioned 80%/20% between the owners of Carbise and the non-controlling interest. Only the current year's exchange difference would initially be recorded within other comprehensive income for the year ended 31 December 2016 whereas cumulative exchange differences on goodwill at 30 September 2016 would be recorded within equity.

(b) The net assets of Bikelite would have been retranslated each year at the closing rate of exchange. There is therefore an exchange difference arising each year by comparing the opening net assets at the opening rate of exchange with the opening net assets at the closing rate of exchange. An additional exchange difference arises through the profit or loss of Bikelite each year being translated at the average rate of exchange in the consolidated statement of comprehensive income. The profit or loss will increase or decrease the net assets of Bikelite respectively which, as is indicated above, will be translated at the closing rate of exchange within the consolidated statement of financial position. As with goodwill, the exchange differences are included within equity with 80% attributable to the shareholders of Carbise and 20% to the NCI. Cumulative exchange differences will be included within the consolidated statement of financial position with just current year differences recorded within other comprehensive income.

The carrying amount of the net assets of Bikelite on 1 January 2016 was shillings 48 million. The fair value of their opening net assets therefore would be shillings 64 million (shillings 48 + 16/20 x shillings 20 million). Bikelite would only be consolidated for the first nine months of the year since Carbise loses control on 30 September 2016. Losses per the individual accounts for the year ended 31 December 20X6 were shillings 8 million, so only shillings 6 million would be consolidated. Additional depreciation of shillings 0·75 million (shillings 20m/20 x 9/12) would be charged for the first nine months of the year. Net assets at disposal in shillingss would therefore be shillings 57·25 million (shillings 64 – shillings 6·75). The exchange difference arising in the statement of comprehensive income for the year ended 31 December 2016 would be Rs.13·4 million calculated as follows:

	Rs. millions
Opening net assets at opening rate (shillings 64/0·38)	168·4
Loss for 9 months at average rate (shillings 6·75/0·37)	(18·2)
Current year exchange gain (balance)	13·4
Net assets at 30 September 2016 (shillings 57·25/0·35)	163·6

Rs.10·7 million of the exchange differences are attributed to the shareholders of Carbide (80% x Rs.13·4) and Rs.2·7 million to the NCI.

(c) (i) Group profit or loss on disposal on Bikelite

	Rs. millions
Proceeds	150
Net assets at disposal (see (b))	(163·6)
Goodwill at disposal (see (a)(ii))	(102·9)
NCI at disposal	48·5
Exchange gains recycled to profit and loss	76·6
Group profit on disposal	8·6

Workings

Exchange gains at 1 January 2016 per question are Rs.74·1 million. Current year exchange differences on goodwill are Rs.8·2 million (see (b)(i)) and on the net assets are Rs.13·4 million (see (b)). Cumulative exchange gains at 30 September 2016 are therefore Rs.95·7 million. On disposal, the parent's share (80%) = Rs.76·6 million should be recycled to profit or loss.

NCI at disposal is calculated as follows:

	Rs. millions
NCI at 1 January 2016 per question	47·8
NCI share of loss to 30 September 2016	
(20% x shillings 6·75m (see (b))/0·37)	(3·6)
NCI share exchange gains for 9 months to 30 September 2016	
(20% x (13·4 + 8·2))	4·3
NCI at 30 September 2016	48·5

(ii) For the year ended 31 December 2016, Carbise will consolidate Bikelite for the first nine months of the year up to the date of disposal of the shares and subsequent loss of control. NCI will be calculated on the first nine months of losses. Exchange differences on the translation of the net assets, profits and goodwill in relation to the nine months to 30 September 2016 will initially be recognised in other comprehensive income classified as gains which will be reclassified subsequently to profit or loss.

On 30 September 2016, a consolidated profit or loss on disposal will be calculated in the consolidated financial statements of Carbise. In effect, the proceeds are compared to the net assets and unimpaired goodwill not attributable to the non‑controlling interest at the disposal date. The cumulative exchange differences on the translation of Bikelite would be reclassified to profit or loss.

Consideration should be given as to whether the disposal of Bikelite would constitute a discontinued operation. For Bikelite to be classified as a discontinued operation, it would need to represent a separate major line of business or geographical area of operations. Since Bikelite was initially acquired by Carbise to gain easier access to international markets, it is likely that the criterion would be met.

Question 4

Kerry Plc had a 60% investment in Berry Ltd for two years. Kerry is now disposing this investment. Goodwill had been calculated using the full goodwill method and by the date of disposal the goodwill has been impaired by 20%.

Following details are available:

	Rs'000
Cost of the investment	6,000
Berry Ltd – Net assets on acquisition date	5,500
Berry Ltd – Fair value of NCI on acquisition date	2,800
Berry Ltd – Net assets on disposal date	6,400
Sales proceeds	8,000

Calculate the gain or loss on disposal

Question 5

Pinnacle PLC is looking at investing in Gama PLC which has both foreign operations and transactions. 60% of the raw materials required for productions within the group of companies are imported from China, India, and Europe. 50% of the production of Gama PLC is exported to European counties and the USA as well. Foreign stake in the equity of Gama PLC amounts to 25% and Gama PLC has been maintaining good dividend records throughout its history and the last dividend paid was Rs. 5 per share. Around 10% of key managerial positions of Gama PLC is held by expatriates.

The total equity of Gama PLC as of 31.12.2019 was Rs. 800 million and the stated capital consists of 15 million shares. The market price of a share as of 31.12.2019 was Rs. 60.

1.) Acquisition of Gama PLC

a.) Pinnacle PLC is considering acquiring a controlling stake in Gama PLC and is concerned on the determination of the functional currency of Gama PLC. 25% of shares of Gama are held by a foreign party whose functional currency is USD. All transactions by Gama with other countries are denominated and settled in USD. Local transactions are settled in LKR. Gama raises funding on its own from local and foreign sources and does not depend on the foreign shareholder for funding. The cash generated are retained in LKR but a portion is maintained in USD for transaction settlement. The salaries of the expatriate employees are agreed and settled in USD while other employees salaries are denominated and settled in LKR. The foreign shareholder has representation in the board of Gama but Gama as an entity functions autonomously.

You are required to evaluate and advice on what should be considered as the functional currency of Gama in line with the requirements of LKAS 21 in determining the functional currency of an entity.

b.) On 31st December 2019, Pinnacle acquired 70% of Gama for a consideration of Rs. 670mn. Gama had a foreign subsidiary, Beta Ltd, in which it owned 60% and the investment in Beta was carried at cost of Rs. 100mn which Gama incurred when it acquired Beta in January 2019. The fair value of this investment as at 31st December 2019 was Rs.190mn. on 1 January 2019 the net assets of Beta was as follows.

	USD'mn
Share capital	0.50
Retained earnings	0.20
Total equity	**0.70**

The Statement of Financial Position of Gama and Beta as at 31st December 2019 is given below.

	Gama PLC	**Beta Ltd**
	Rs 'Mn	**USD'Mn**
Non Current Assets		
PPE	1,000	2.00
Investment in Beta	100	-
Current assets	800	1.00
Total Assets	**1,900**	**3.00**
Share capital	150	0.50
Retained earnings	650	0.75
Total equity	**800**	**1.25**
Non current liabilities	500	0.60
Current liabilities	600	1.15
Total equity and liabilities	**1,900**	**3.00**

The fair value of the net assets of Gama was equal to the book value except for the investment in Beta. Beta had a land which had a fair value of USD 500,000 in excess of it's carrying amount. The acquisition date NCI of Gama is to be measured at fair value and NCI of Beta is to be measured at proportion of Net Assets.

The exchange rates are as follows.

	1 USD = LKR
1.1.2019	160
2019 Average	170
31.12.2019	180

Prepare a summary to the board of Directors of Pinnacle PLC on the above acquisition of Gama PLC showing the Goodwill calculations and effect on the consolidated financial statements of Pinnacle PLC on the following items.

1.) Non-current assets
2.) Goodwill
3.) Current assets
4.) NCI
5.) Non-current liabilities
6.) Current liabilities

c.) The board of directors of Pinnacle PLC are concerned on the exchange rate fluctuations and has asked you to prepare a summary of the financial impact arising from its investment in Beta if the exchange rate moved as follows in each quarter in the year 2020.

	1 USD = LKR
1.1.2020	180
1st Qtr avg	185
31.3.2020	190
2nd Qtr avg	205
30.6.2020	220
3rd Qtr avg	210
30.9.2020	200

Beta Ltd is expected make profits as follows.

	USD'Mn
Jan-Mar 2020	0.30
Apr-Jun 2020	0.40
Jul-Sep 2020	0.50