
Answers

1 (a) Joey plc

Consolidated statement of financial position at 30 November 2014

	\$m
Assets:	
Non-current assets	
Property, plant and equipment (W8)	6,709
Goodwill (W1)	89
Intangible assets – franchise right (W2)	15
Investment in joint venture (W10)	0.75
	6,813.75
Current assets (W6)	2,011.3
Total assets	8,825.05
Equity and liabilities:	
Equity attributable to owners of parent	
Share capital	850
Retained earnings (W4)	3,450.25
Other components of equity (W5)	258.5
	4,558.75
Non-controlling interest (W7)	908.1
Non-current liabilities (W9)	2,770
Current liabilities (W9)	588.2
Total liabilities	3,358.2
Total equity and liabilities	8,825.05

Working 1 Margy

	\$m	\$m
Fair value of consideration for 40% interest		975
Non-controlling interest – fair value		620
Previously held interest of 30% – fair value		705
Fair value of identifiable net assets acquired:		
Share capital	1,020	
Retained earnings	900	
OCE	70	
FV adjustment – land (balance)	266	
– contingent liability	(6)	
		(2,250)
Add decrease in fair value of buildings		40
Measurement period adjustment – contingent liability (\$6m – \$5m)		(1)
Goodwill		89

Tutorial note

The carrying amount of Margy at 1 December 2013 is (cash \$600 + profit \$90m + revaluation gain \$10m) \$700 million and this interest is fair valued at the date of acquisition to \$705 million, giving a revaluation gain of \$5 million which goes to profit or loss. The previous revaluation gain of \$10 million would not be reclassified to profit or loss even if the interest in Margy were disposed of.

The carrying amount of property, plant and equipment as of 30 November 2014 is decreased by \$40 million less the excess depreciation charged of \$2 million, i.e. \$38 million. The carrying amount of goodwill is increased by \$40 million and depreciation expense for 2014 is decreased by \$2 million. This latter decrease in expense is split between retained earnings (\$1.4m) and NCI (\$0.6m).

IFRS 3 Business Combinations requires Joey to measure contingent liabilities subsequent to the date of acquisition at the higher of the amount which would be recognised in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets, and the amount initially recognised, less any appropriate cumulative amortisation in accordance with IAS 18 Revenue. These requirements should be applied only for the period in which the item is considered to be a contingent liability. In this case, the contingent liability has subsequently met the requirements to be reclassified as a provision, and will be measured in accordance with IAS 37 rather than IFRS 3.

As a result the liability has been measured at March 2014 at \$5 million, and recognised through profit or loss during the year ended 30 November 2014. This represents a pre-combination loss which must be credited back to NCI and group reserves. Therefore NCI is credited with \$1.5 million and retained earnings with \$3.5 million.

Working 2 Hulty

Joey measures the gain on its purchase of the 80% interest in Hulty as follows:

	\$m	\$m
Purchase consideration – Hulty		700
Non-controlling interest		250
Less fair value of identifiable net assets:		
Share capital	600	
Retained earnings	300	
OCE	40	
FV – franchise right	20	
		(960)
Gain on bargain purchase		(10)

The gain of \$10 million is recognised in profit or loss. Additionally, Joey recognises an identified intangible asset for the reacquired right at its fair value of \$20 million. This right will be amortised over the remaining term of the franchise agreement of four years. Thus \$5 million will be credited to the franchise right account (to give a balance of \$15 million) and debited to retained earnings \$4 million and NCI \$1 million.

Working 3 Asset held for sale

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* criteria are met at 31 March 2014. Therefore, Joey should depreciate the property until the date of reclassification as held for sale. Thus, the depreciation charge is $\$300,000 \times 4/12 = \$100,000$. The carrying value of the property is therefore \$13.9 million.

The property should be revalued to its fair value at that date of \$15.4 million as the difference between the property's carrying amount at that date and its fair value is deemed to be material. The revaluation increase of \$1.5 million is recognised in other comprehensive income in accordance with IAS 16 *Property, Plant and Equipment*.

Joey should consider whether the property is impaired by comparing its carrying amount (fair value) with its recoverable amount (higher of value in use and fair value less costs to sell). No impairment loss is recognised because value in use of \$15.8 million is higher than fair value less costs to sell of \$15.1 million. The property should be reclassified as held for sale and remeasured to fair value less costs to sell (\$15.1 million), which results in the recognition of a loss of \$300,000 which should be recognised in profit or loss.

When the property is disposed of on 30 November 2014, a profit on disposal of \$200,000 is recognised (net proceeds of \$15.3 million less carrying amount of \$15.1 million). Any remaining revaluation reserve relating to the property is not recognised in profit or loss, nor transferred to retained earnings in accordance with IAS 16 because of group policy.

Accounting entries

Dr Profit or loss	\$100,000
Cr Property	\$100,000

The depreciation up to the date of reclassification as held for sale.

Dr Property	\$1.5 million
Cr OCI	\$1.5 million

The increase in the value of the property to fair value at the date of the reclassification.

Dr Profit or loss	\$300,000
Cr Property	\$300,000

Loss arising on reclassification.

Dr Accounts receivable	\$15.3 million
Cr Property	\$15.1 million
Cr Profit or loss	\$0.2 million

The disposal of the property at the year end.

Working 4 Retained earnings

	\$m
Joey	
Balance at 30 November 2014	3,340
Revaluation gain – Margy	5
Depreciation reduction (70% x 2)	1.4
Liability adjustment (70% x 5)	3.5
Amortisation – franchise right (80% x 5)	(4)
Gain on bargain purchase	10
Asset held for sale – depreciation prior to reclassification (W3)	(0.1)
Asset held for sale – remeasurement (W3)	(0.3)
Asset held for sale – gain on sale (W3)	0.2
Joint operation (W10)	(0.7)
Joint venture (W10)	0.75
Joint venture (W10)	(1.5)
Post-acquisition reserves: Margy (70% of (980 – 900))	56
Hulty (80% of (350 – 300))	40
	3,450.25

Working 5 Other components of equity

	\$m
Balance at 30 November 2014 – Joey	250
Asset held for sale (W3)	1.5
Post-acquisition reserves: Margy post acquisition (70% of 80 – 70)	7
Hulty (80% x (40 – 40))	0
	258.5

Working 6 Current assets

	\$m
Balance at 30 November 2014	
Joey	985
Margy	861
Hulty	150
Sale of property (W3)	15.3
	2,011.3

Working 7 Non-controlling interest

	\$m
Margy (W1)	620
Hulty (W2)	250
Post-acquisition retained earnings – Margy (30% of 980 – 900)	24
Post-acquisition retained earnings – Hulty (20% of 350 – 300)	10
OCE – post acquisition – Margy (30% of 80 – 70)	3
OCE – post acquisition – Hulty (20% of 40 – 40)	0
Depreciation reduction (30% x 2)	0.6
Franchise right – amortisation (20% x 5)	(1)
Liability adjustment (30% x 5)	1.5
	908.1

Working 8 Property, plant and equipment

	\$m	\$m
Balance at 30 November 2014		
Joey	3,295	
Margy	2,000	
Hulty	1,200	
		6,495
Decrease in value of building – Margy (W1)	(38)	
Increase in value of land – Margy (W1)	266	
Asset held for sale – depreciation prior to reclassification (W3)	(0.1)	
Asset held for sale – remeasurement prior to reclassification	1.5	
Asset held for sale – remeasurement after reclassification	(0.3)	
Asset held for sale – disposal	(15.1)	214
		<u>6,709</u>

Working 9 Liabilities

	\$m	\$m
Non-current liabilities – balance at 30 November 2014		
Joey	1,895	
Margy	675	
Hulty	200	
		<u>2,770</u>
	\$m	\$m
Current liabilities – balance at 30 November 2014		
Joey	320	
Margy	106	
Hulty	160	
Joint operation – CP	0.7	
Joint venture	1.5	
		<u>588.2</u>

Working 10 Joint venture

For the period to 31 May 2014, the requirement for unanimous key strategic decisions means this is a joint venture. Since there is no legal entity, it would be classified as a joint operation. Joey would account for its direct rights to the underlying results and assets.

Up until 31 May 2014, the joint operation had the following results:

	\$m
Revenue (5 x 6/12)	2.5
Cost of sales (2 x 6/12)	(1)
Gross profit	<u>1.5</u>

What belongs to Joey is therefore:

	\$m
Sales (90% x 2.5)	2.25
Cost of sales (printing, binding, platform – all by Joey)	(1)
Gross profit	1.25
Profit royalty to CP (calculated as 30% of \$1.5m)	(0.45)
Net profit	<u>0.8</u>

Therefore Joey should adjust the accounting for the period to 31 May 2014 as follows:

Dr Profit or loss (\$0.45m above + (\$2.5m x 10%), i.e. \$0.25 million)	\$0.7 million
Cr Accounts payable CP	\$0.7 million

From 1 June 2014, Joey has a share of the net assets rather than direct rights; the joint operation would be classified as a joint venture and must be equity accounted. Therefore the adjustment to the current accounting will be:

Remove profit of new entity JCP:

Dr Profit or loss	\$1.5 million
Cr JCP – profit for period	\$1.5 million

Recognise Joey's equity-accounted share of JCP's profit:

Dr Investment in joint venture $((\$5m - \$2m)/2 \times 50\%)$
Cr Profit or loss

\$0.75 million
\$0.75 million

(b) Report to the directors of Joey

Key changes to UK GAAP and eligibility criteria

The Financial Reporting Council in the UK has published three Financial Reporting Standards, which will replace UK GAAP in the UK and Republic of Ireland. These are:

- (1) FRS 100, *Application of financial reporting requirements*;
- (2) FRS 101, *Reduced disclosure framework*; and
- (3) FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. This will be the new FRS for UK GAAP reporters.

FRS 100 sets out the overall financial reporting requirements, giving many entities a choice of detailed accounting requirements depending on factors such as size, and whether or not they are part of a listed group. FRS 100 provides companies with an opportunity to take advantage of reduced disclosures and identifies whether entities need to produce their consolidated or individual financial statements in accordance with EU IFRS, FRS 102 or the Financial Reporting Standard for Smaller Entities (FRSSE).

It does not extend the mandatory application of EU-adopted IFRS. In the absence of a requirement to prepare EU IFRS financial statements, the individual accounts or consolidated accounts of any qualifying entity are prepared in accordance with one of the following:

- (1) EU IFRS
- (2) FRS 101 for the individual accounts of a qualifying entity
- (3) FRS 102
- (4) FRSSE

The last three options above are all 'Companies Act' accounts. FRS 101 provides companies with an opportunity to take advantage of reduced disclosures. However, companies should consider the advantages and disadvantages of the options before making a decision as to which regime to adopt. There are transitional arrangements for entities which change the basis of preparation of their financial statements.

Entities which are not required to use IFRS but wish to use its recognition and measurement requirements can choose to apply FRS 101 in their individual financial statements, benefiting from reduced disclosures, as long as they are qualifying entities. FRS 101 permits UK subsidiaries to adopt EU IFRS for their individual financial statements but within the reduced disclosure framework (RDF). This option is also available for the parent company's individual financial statements. The disclosure exemptions do not apply to consolidated financial statements of intermediate groups, as they are only available for individual financial statements of qualifying entities. FRS 101 contains various exemptions from IFRS disclosures. Some of these require that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated. FRS 102 replaces the majority of current UK accounting standards and adopts an IFRS-based framework with proportionate disclosure requirements and improves the accounting and reporting for financial instruments. It is based on the IFRS for SMEs but with significant changes in order to address company law and to include extra accounting options.

A qualifying entity for these purposes is one which is a member of a group where the parent of that group prepares publicly available consolidated financial statements, and that member is included in the consolidation.

In order to use RDF, the shareholders should have been notified in writing and those holding a certain percentage of shares have not objected, EU adopted IFRS have been applied and the financial statements make specified disclosures relating to the exemptions.

A shareholder may object to the use of the disclosure exemptions only if the shareholder is the immediate parent of the entity, if the shareholder or shareholders hold more than half of the allotted shares in the entity which are not held by the immediate parent, or if the shareholder or shareholders hold 5% or more of the total allotted shares in the entity.

- (c)** Joey needs a significant injection of capital in order to modernise plant and equipment and the bank requires the company to demonstrate good projected cash flow and profitability. However, the projected cash flow statement does not satisfy the bank's criteria and the directors have told the bank that the financial results will meet the criteria. Thus there is pressure on the chief accountant to forward a financial report which meets the bank's criteria. The chief accountant cannot afford to lose his job because of his financial commitments and this in itself creates an ethical dilemma for the accountant, as not only is there self-interest of the accountant involved but also the interests of the company and its workforce. The accountant has to rely upon his moral and ethical judgement in these circumstances.

Ethical standards are used by members of a profession to decide the right course of action in given circumstances. Ethics rely on logical and rational reasoning to reach a decision, morals are a behavioural code of conduct to which an individual ascribes and ethical rules create an obligation to undertake a particular course of action. Conflict can arise between personal and ethical values but when an individual becomes a member of a profession, there is a recognition that there is acceptance of the standards of that profession which include its code of ethics and values. The ethical rules of the accounting profession represent an attempt to codify principles. A profession is distinguished by having a specialised body of knowledge, a social

commitment, the ability to regulate itself and high social status. The profession should seek to promote or preserve public interest. Professional accountants make a bargain with society in which they promise to serve the public interest which may, at times, be at their own expense. Accountants, as professionals, cannot rely exclusively on rules to define how they will act ethically. Members of the profession have a responsibility to present the truth in a fair and honest fashion and in a spirit of public service. In such circumstances, accountants should think carefully before seeking creative accounting solutions to particular problems. Thus, in this case, the chief accountant should insist that the report to the bank is a true reflection of the current financial position, irrespective of the consequences for himself.

- 2 (a)** Under IAS 24 *Related Party Disclosures*, disclosures are required in respect of an entity's transactions with related parties. Related parties include parents, subsidiaries, members of key management personnel of the entity or of a parent of the entity and post-employment benefit plans.

Where there have been related party transactions during the period, management discloses the nature of the relationship, as well as information about the transactions and outstanding balances, including commitments, necessary for users to understand the potential impact of the relationship on the financial statements. Disclosure is made by category of related party and by major type of transaction. Management only discloses that related party transactions were made on terms equivalent to those which prevail in arm's length transactions if such terms can be substantiated.

Government-related entities are defined as entities which are controlled, jointly controlled or significantly influenced by the government. The financial crisis widened the range of entities subject to the related party disclosure requirements. The financial support provided by governments to financial institutions in many countries meant that the government controls significantly influenced some of those entities. A government-controlled bank would, in principle, be required to disclose details of its transactions, deposits and commitments with all other government-controlled banks and with the central bank. However, IAS 24 has an exemption from all of the disclosure requirements of IAS 24 for transactions between government-related entities and the government, and all other government-related entities. Coatmin is exempt from the disclosure requirements in relation to related party transactions and outstanding balances, including commitments, with:

- (a) a government which has control, joint control or significant influence over the reporting entity; and
- (b) another entity which is a related party because the same government has control, joint control or significant influence over both the reporting entity and the other entity.

Those disclosures are replaced with a requirement to disclose:

- (a) the name of the government and the nature of their relationship; and
- (b) (i) the nature and amount of any individually significant transactions; and
(ii) the extent of any collectively significant transactions qualitatively or quantitatively.

The disclosures provide more meaningful information about the nature of an entity's relationship with the government and material transactions.

- (b)** IFRS 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 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and
 - (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 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.

- (c) IAS 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.

IAS 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 1 December 2013	Fair value 30 November 2014	Change in value
	\$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. IAS 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.

- (d) IFRS 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. IFRS 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.

- 3 (a)** The accounting for the transaction as an asset acquisition does not comply with the requirements of IFRS 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 IFRS 3, an entity should determine whether a transaction is a business combination by applying the definition of a business in IFRS 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.

IFRS 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 choose 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 IFRS 3.

IFRS 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, IFRS 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.

(b) Report to directors of Kayte

Business implications of new UK GAAP and specific accounting issues

For many entities, there may be a cash tax impact as a result of the transition away from current UK and Irish GAAP, which will impact the tax payable to or receivable from HM Revenue and Customs. UK tax liabilities are based upon local entity accounting profits. It is important that stakeholders understand this. Differing treatments of goodwill, lease incentives and intangible assets can affect tax outcomes. Where accounting adjustments are made on transition, these may impact the amount of distributable reserves. Additionally, changes to the accounting and financial reporting requirements will often require information not previously compiled. Entities will need to consider whether their existing systems and reporting structures can provide all of the information required under the new accounting framework.

Employee remuneration packages are often linked to accounting performance through profit-related bonus arrangements and share option arrangements and these remuneration arrangements will need to be assessed to understand the potential impact. It may be necessary to agree revised financial terms. Often banking covenants or other finance arrangements are linked to key financial reporting measures. It may be necessary to renegotiate borrowing arrangements. Entities will need to consider how they will manage the transition and consider how they will approach the training of the necessary finance team members under a new accounting framework. A challenge for groups is the rolling out of the new accounting frameworks across a number of companies. It may be useful to consider entity rationalisation in order to simplify their structure to ensure the most efficient transition.

It is essential to manage the expectations of those affected across the business. The board of directors must fully understand the extent of the changes and determine a communications strategy to address the need of all stakeholders.

The section on income tax in IFRS for SMEs has been replaced completely in IFRS 102 *The Financial Reporting Standard* applicable in the UK and Republic of Ireland.

A current tax liability is recognised for tax payable on taxable profit for the current and past periods. If the amount of tax paid for the current and past periods exceeds the amount of tax payable for those periods, the excess is recognised as a current tax asset. A current tax asset is recognised for the benefit of a tax loss which can be carried back to recover tax paid in a previous period. FRS 102 requires disclosure of the tax expense relating to discontinued operations.

Current tax assets and liabilities and deferred tax assets and liabilities can be offset if there is a legally enforceable right of set-off and there is an intention to settle simultaneously or on a net basis.

FRS 102 recognises deferred tax utilising timing differences, and not temporary differences which is the IFRS for SMEs approach. New UK GAAP requires a new 'timing difference plus' approach which is a similar approach to old UK GAAP but with specific additional adjustments required to recognise additional deferred tax balances. It is probable that the result will be similar to that under IFRS for SMEs, except in rare circumstances. Timing differences are differences between taxable profit and accounting profit which originate in one period and reverse in one or more subsequent periods. Timing differences arise because certain items are included in the accounts of a period which is different from that in which they are dealt with for taxation purposes.

Under FRS 102, deferred taxation should be recognised in respect of all timing differences at the reporting date, subject to certain exceptions and for differences arising in a business combination. Under the IFRS for SMEs, a 'balance sheet' approach is taken, based on temporary differences. Temporary differences are differences between the tax base of an asset or liability and its carrying amount in the statement of financial position.

Both FRS 102 and IFRS for SMEs prohibit discounting of deferred tax assets and liabilities.

- 4 (a)** All assets, including goodwill and intangible assets, have to be tested for impairment at the end of each reporting period, if there are indicators of impairment. The main issues in relation to IAS 36 *Impairment of Assets* are as follows:

Changes in circumstances

Changes in circumstances between the date of the impairment test and the next reporting period end may give rise to impairment indicators. If so, more than one impairment test may be required in an annual period. Where an annual impairment test is required for goodwill and certain other intangible assets, IAS 36 allows the impairment test to be performed at any time during the period, provided it is performed at the same time every year.

Many entities test goodwill at an interim period in the year. In times of high uncertainty, goodwill may have to be tested for impairment at year end and at a subsequent interim reporting date as well, if indicators of impairment arise after the annual test has been performed.

If an entity has to test for impairment at the end of the reporting date as well as at the scheduled annual date, it does not necessarily mean that the whole budget process needs to be redone, as top-down adjustments may be sufficient to assess any changes in the period since the latest goodwill impairment review.

Volatility in financial statements may indicate impairment. For example, falls or rises in commodity prices may affect impairment indicators for energy and mining entities, and require those assets to be tested for impairment in the next interim financial statements.

Market capitalisation as a special impairment indicator

Market capitalisation is a powerful indicator as, if it shows a lower figure than the book value of net assets, it inescapably suggests the market considers that the business is overvalued. However, the market may have taken account of factors other than the return which the entity is generating on its assets. A market capitalisation below book equity will not necessarily lead to an equivalent impairment loss. Entities should examine their cash generating units (CGUs) in these circumstances and may have to test goodwill for impairment. IAS 36 does not require a formal reconciliation between market capitalisation of the entity, fair value less costs to sell (FVLCS) and value in use (VIU). However, entities need to be able to understand the reason for the shortfall.

Allocating and reallocating goodwill to cash generating unit (CGU)

Given the complexity, sensitivity and need for significant judgement, companies experience issues assessing goodwill for impairment. The identification of CGUs and the allocation of acquired goodwill is unique to each entity and requires significant judgement. This allocation process in itself determines the appropriate carrying amount to test and should be a reasonable and supportable method.

Acquired goodwill is allocated to each of the acquirer's CGUs, or to a group of CGUs, which are expected to benefit from the synergies of the combination. If CGUs are subsequently revised or operations disposed of, IAS 36 requires goodwill to be reallocated, based on 'relative values', to the units affected. However, the standard does not expand on what is meant by 'relative value'. It does not mandate FVLCS as the basis, but it might mean that the entity has to carry out a valuation process on the part retained. There could be reasonable ways of estimating relative value by using an appropriate industry or business surrogate (for example, revenue, profits, industry KPIs).

Valuation issues

IAS 36 requires the recoverable amount of an asset or CGU to be measured as the higher of the asset's or CGU's FVLCS and VIU. Measuring the FVLCS and VIU of an asset or CGU requires the use of assumptions and estimates.

The following issues are proving particularly troublesome:

- (a) The use of a discounted cash flow (DCF) methodology to estimate FVLCS.
- (b) Determining the types of future cash flows which should be included in the measurement of VIU, in particular, those relating to restructuring programmes. IAS 36 requires an asset or CGU to be tested in its current status, not the status which management wishes it was in or hopes to get it into in the near future. Therefore, the standard requires VIU to be measured at the net present value of the future cash flows the entity expects to derive from the asset or CGU in its current condition over its remaining useful life. This means ignoring many management plans for enhancing the performance of the asset or CGU.
- (c) Determining the appropriate discount rate to apply. Unlike the cash flows used in an impairment test which are entity-specific, the discount rate is supposed to appropriately reflect the current market assessment of the time value of money and the risks specific to the asset or CGU.

When a specific rate for an asset or CGU is not directly available from the market, which is usually the case, the entity's weighted average cost of capital (WACC) can be used as a starting point. While not prescribed, WACC is by far the most commonly used base for the discount rate. However, the appropriate way to calculate the WACC is a complex subject, but the objective must be to obtain a rate, which is sensible and justifiable. In any event the rate can be subjective.

- (d) The impact of taxation on the impairment test, given the requirement in IAS 36 to measure VIU using pre-tax cash flows and discount rates. VIU, as defined by IAS 36, is primarily an accounting concept and not necessarily a business valuation of the asset or CGU. For calculating VIU, IAS 36 requires pre-tax cash flows and a pre-tax discount rate.

WACC is a post-tax rate, as are most observable equity rates used by valuers. Because of the issues in calculating an appropriate pre-tax discount rate and because it aligns more closely with their normal business valuation approach, some entities attempt to perform a VIU calculation based on a post-tax rate and post-tax cash flows.

- (e) Ensuring that the recoverable amount and carrying amount which are being compared are consistently determined. For example, pensions are mentioned by IAS 36 as items which might be included in the recoverable amount of a CGU. In practice, this could be fraught with difficulty, and entities will have to reflect the costs of providing pensions to employees and may need to make a pragmatic allocation to estimate a pension cost as part of the employee cost cash flow.
- (f) The incorporation of corporate assets into the impairment test. If possible, the corporate assets are to be allocated to individual CGUs on a 'reasonable and consistent basis'. This is not expanded upon in IAS 36 and affords some flexibility, but can lead to inconsistency. The same criteria must be applied at all times.

Goodwill impairment disclosures

Disclosure is a key communication to investors by management. Disclosures which describe the factors which could result in impairment become even more important when value has been eroded. Goodwill impairment disclosures are a requirement, but can be a problem. The key question is whether sufficient disclosure has been made about the uncertainty of the impairment calculation. Sensitivity disclosures about adverse situations, such as those triggered by volatile prices, provide useful information and whether a possible change in a key assumption, such as the discount rate, could lead to recoverable amount being equal to carrying amount, or result in impairment losses.

- (b) (i) The discount rate used by Estoil has not been calculated in accordance with the requirements of IAS 36 *Impairment of Assets*. According to IAS 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. IAS 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 IAS 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 IAS 36. IAS 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. IAS 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 IAS 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.

IAS 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 IAS 36.

	<i>Marks</i>
1 (a) Property, plant and equipment	5
Goodwill	6
Assets held for sale	5
Current assets/total non-current liabilities	1
Retained earnings	6
Other components of equity	3
Non-controlling interest	3
Current liabilities	1
Joint venture	5
	<u>35</u>
(b) Subjective assessment of discussion 1 mark per element	8
(c) Subjective assessment – 1 mark per point	7
	<u>50</u>
2 (a) IAS 24	5
(b) IFRS 9 explanation Guarantee calculations	3 4
(c) Hedging discussion Effectiveness discussion	4 3
(d) Credit risk entries	4
Professional marks	2
	<u>25</u>
3 (a) IFRS 3/IFRS 10 – 1 mark per point up to	12
(b) 1 mark per point up to	11
Professional marks	2
	<u>25</u>
4 (a) Subjective issues – 1 mark per point	13
(b) Subjective	10
Professional marks	2
	<u>25</u>