Examiner's report

DipIFR

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General Comments

The examination consisted of four compulsory questions. Section A contained one question for 40 marks. This question involved discussion of the treatment of a given significant investment and the preparation of a consolidated statement of profit or loss and other comprehensive income.

Section B comprised three further questions of 20 marks each. These three questions all required candidates to discuss the financial treatment of a number of different issues:

- Question 2 required the analysis of the treatment of a cash settled share-based payment, the treatment a legal sale of inventory where the risks and rewards of ownership were retained, and the treatment of an operating lease including a lease incentive in the form of a rent-free period.
- Question 3 was a single-topic scenario question that focussed on various aspects of deferred tax.
- Question 4 required the analysis of the treatment of a transaction with a related party, the treatment of advertising costs, and the treatment of the purchase of property, plant and equipment where the transaction was denominated in foreign currency.

The majority of candidates attempted all four questions, and there was little evidence of time pressure. Where questions were left unanswered by candidates, there was evidence to suggest that this was due to a lack of knowledge or poor exam technique.

Specific Comments

Question One

This question presented candidates with the financial statements of a parent entity (Alpha) and two subsidiaries (Beta and Gamma). Share ownership by Alpha in Gamma was only 40% but under the principles of IFRS 10 – *Consolidated Financial Statements* – Gamma was a subsidiary due to the fact that the other shares were held by a wide variety of investors. Candidates were asked in part (a) (for 5 marks) to analyse the status of Gamma in Alpha's consolidated financial statements and then in part (b) (for 35 marks) to prepare Alpha's consolidated statement of profit or loss and other comprehensive income under the assumption that Gamma should be treated as a subsidiary.

Answers to part (a) were, on the whole, disappointing. The majority of candidates who attempted this part (and some candidates did not) referred to the requirements of IAS 27 – which no longer deals with consolidated financial statements. It is clearly important to ensure that technical knowledge is updated when standards change. A number of candidates incorrectly concluded that Gamma was not a subsidiary but an associate and then proceeded to treat Gamma as such in part (b) despite clear instructions on the paper to treat Gamma as a subsidiary in part (b). It is important that candidates read and question requirements carefully.

As is customary in questions of this type answers to part (b) showed that many candidates had a sound knowledge of consolidation techniques and basic consolidation adjustments. Adjustments necessary to eliminate intra-group sales and account for the effect of fair value adjustments were, on the whole, made to a satisfactory standard. However candidates were generally less sure of how to account for the deferred tax effects of the fair value adjustments, often reflecting these tax effects through consolidated cost of sales rather than through the consolidated tax charge. Also, many candidates seemed unaware of the fact that existing contingent liabilities of an acquired subsidiary are measured at fair value in the consolidated financial statements, both on acquisition and subsequently.

In addition to the adjustments already referred to above, candidates were also required to correct the financial reporting treatment of two items from the draft financial statements of Alpha – the parent. The first of these adjustments was to include the appropriate entries in both profit or loss and in other comprehensive income for a senior executive defined benefit retirement plan . In the draft financial statements, the contributions for the period had been treated as an expense. Whilst a number of very good answers were produced for this adjustment, some fairly basic errors were made by many candidates. The most common errors were:

- Making the adjustments required by IAS 19 – *Employee Benefits* – but failing to remove the contributions expense from profit or loss.
- Using the incorrect discount rate to unwind the discount on the net pension liability, or using a different rate for the gross liability and the pension asset.
- Including the actuarial difference in profit or loss rather than other comprehensive income.

The second adjustment to the financial statements of Alpha related to the hedge of currency risk of a future firm commitment. Candidates were told that the type of hedge accounting to be used was cash-flow hedge accounting where the hedge accounting rules allow a choice (as is the case with the foreign currency risk attaching to a future firm commitment). A minority of candidates ignored this adjustment completely (presumably because they did not know how to deal with it) but, this said, a number of good answers were produced here which showed a pleasing level of knowledge.

Question Two – three part analysis question

On the whole the answers to this three-part analysis question were satisfactory. Comments on the specific parts are as follows:

Part a – share-based payment

Roughly half the candidates answering this part did so from the perspective that the transaction with the executives was equity settled, rather than cash settled. This produced two inevitable errors:

- Using the fair value of the right at the grant date rather than the latest fair value when computing the cost.
- Crediting equity rather than liabilities when debiting the cost to profit or loss.

The treatment of the vesting condition (a non-market service condition) was, on the whole, handled well by candidates so that, even those who made the errors previously described, were able to gain partial credit in this part.

Part b – the sale of inventory

This part was answered well and most correctly concluded that the sale of the inventory should not stand given the conditions attaching to it.

Part c – the machinery lease

The majority who answered this correctly identified that it was an operating lease. However, of this number, a minority then incorrectly stated that no rental expense would be charged to profit or loss in the 'rent free' period. Relatively few candidates were able to correctly conclude that the result of the 'rent free' period was to cause an accrual for rent payable to arise, part of which was a current liability and part a non-current liability.

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Question Three – deferred tax question

Answers to this question were, on the whole, unsatisfactory. This could of course simply be due to the fact that deferred tax is a complex topic. However, it may also be due to the fact that candidates had endeavoured to 'question spot' (deferred tax was examined in December 2013). It is evident from the last two examination sittings that such a strategy is flawed and there is no reason why being examined in one sitting means that a topic cannot be examined in the next sitting. Quite apart from being an examinable issue in section B questions, deferred tax adjustments also often feature in the consolidation that appears in question one.

Part a – discussion of tax base and the IAS 12 recognition and disclosure requirements

Many candidates did not appear to know the basic principles of how to compute the tax base of an asset or liability and the basic recognition requirements. A significant minority of candidates left out this part of the question completely despite not appearing to be under any significant time pressure. That said, a minority of candidates produced excellent answers to part (a), which should have been straightforward for well-prepared candidates.

Part b – application to five specific scenarios – a tax loss, a disallowable provision, capitalised development costs, impairment of goodwill and a zero-coupon loan

Candidates were specifically asked to focus on the deferred tax implications of each individual scenario. However, a number of candidates wasted time by talking at length about the pre-tax financial reporting treatments of each scenario, for which very few marks were available. For candidates that did address the deferred tax issues, common errors made were:

- Failing to appreciate that a tax loss is only a deferred tax asset if there is a reasonable expectation of taxable profits in the future.
- Confusing taxable and deductible temporary differences. Many said that the deferred tax effect of the provision was to create a deferred tax liability and that the development expenditure created a deferred tax asset.
- Failing to appreciate that goodwill on consolidation (and therefore any subsequent impairment) is completely outside the deferred tax requirements of IAS 12 – *Income Taxes*.

Question Four – three part analysis question

On the whole the answers to this three-part analysis question were satisfactory. Comments on the specific parts are as follows:

Part a – identification of a related party transaction

The scenario involved a transaction with a company (Sigma) that was controlled by the spouse of one of the directors of the reporting entity (Omega). A number of candidates incorrectly concluded that Sigma was a subsidiary of Omega and should therefore be consolidated, completely missing the related party issue. Another common mistake was to state that, due to the relationship between Omega and Sigma, international financial reporting standards (IFRS) required the transactions to be accounted for at normal market rates. This shows a significant misunderstanding of the role of IFRS.

Part b – advertising expenditure

On the whole this part was well answered, with the vast majority of candidates appreciating that IAS 38 – *Intangible Assets* – effectively prohibits the capitalisation of advertising expenditure as an intangible asset.

However, not all candidates appreciated that payments made for television advertisements not yet shown should be treated as pre-payments.

Part c – foreign currency transaction

Many good answers were also provided to this part. However, not all candidates appreciated that the purchased machine, being a non-monetary asset that is measured under the cost model, would continue to be reported using the rate of exchange in force at the date of acquisition.