Strategic Professional – Essentials

Strategic Business Reporting – United Kingdom

Specimen Exam applicable from September 2018

Paper SBR – UK

Time allowed: 3 hours 15 minutes

This question paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – BOTH questions are compulsory and MUST be attempted

Do NOT open this question paper until instructed by the supervisor.

This question paper must not be removed from the examination hall.

Think Ahead ACCA

The Association of Chartered Certified Accountants

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The question paper begins on page 3.

Section A – BOTH questions are compulsory and MUST be attempted

1 Background and financial statements

The following group financial statements relate to the Kutchen Group which comprised Kutchen, House and Mach, all public limited companies.

Group statement of financial position as at 31 December 20X6

	$m
Assets:	
Non-current assets	
Property, plant and equipment	365
Goodwill	–
Intangible assets	23
	388
Current assets	133
Total assets	521
Equity and liabilities	
Share capital of $1 each	63
Retained earnings	56
Other components of equity	26
Non-controlling interest	3
	148
Non-current liabilities	101
Current liabilities	
Trade payables	272
Total liabilities	373
Total equity and liabilities	521

Acquisition of 70% of House

On 1 June 20X6, Kutchen acquired 70% of the equity interests of House. The purchase consideration comprised 20 million shares of $1 of Kutchen at the acquisition date and a further 5 million shares on 31 December 20X7 if House's net profit after taxation was at least $4 million for the year ending on that date.

The market price of Kutchen's shares on 1 June 20X6 was $2 per share and that of House was $4·20 per share. It is felt that there is a 20% chance of the profit target being met.

In accounting for the acquisition of House, the finance director did not take into account the non-controlling interest in the goodwill calculation. He determined that a bargain purchase of $8 million arose on the acquisition of House, being the purchase consideration of $40 million less the fair value of the identifiable net assets of House acquired on 1 June 20X6 of $48 million. This valuation was included in the group financial statements above.

After the directors of Kutchen discovered the error, they decided to measure the non-controlling interest at fair value at the date of acquisition. The fair value of the non-controlling interest (NCI) in House was to be based upon quoted market prices at acquisition. House had issued share capital of $1 each, totalling $13 million at 1 June 20X6 and there has been no change in this amount since acquisition.

Initial acquisition of 80% of Mach

On 1 January 20X6, Kutchen acquired 80% of the equity interests of Mach, a privately owned entity, for a consideration of $57 million. The consideration comprised cash of $52 million and the transfer of non-depreciable land with a fair value of $5 million. The carrying amount of the land at the acquisition date was $3 million and the land has only recently been transferred to the seller of the shares in Mach and is still carried at $3 million in the group financial statements at 31 December 20X6.

At the date of acquisition, the identifiable net assets of Mach had a fair value of $55 million. Mach had made a net profit attributable to ordinary shareholders of $3·6 million for the year to 31 December 20X5.

The directors of Kutchen wish to measure the non-controlling interest at fair value at the date of acquisition but had again omitted NCI from the goodwill calculation. The NCI is to be fair valued using a public entity market multiple method. The directors of Kutchen have identified two companies who are comparable to Mach and who are trading at an average price to earnings ratio (P/E ratio) of 21. The directors have adjusted the P/E ratio to 19 for differences between the entities and Mach, for the purpose of fair valuing the NCI. The finance director has determined that a bargain purchase of $3 million arose on the acquisition of Mach being the cash consideration of $52 million less the fair value of the net assets of Mach of $55 million. This gain on the bargain purchase had been included in the group financial statements above.

Acquisition and disposal of 80% of Niche

Kutchen had purchased an 80% interest in Niche for $40 million on 1 January 20X6 when the fair value of the identifiable net assets was $44 million. The partial goodwill method had been used to calculate goodwill and an impairment of $2 million had arisen in the year ended 31 December 20X6. The holding in Niche was sold for $50 million on 31 December 20X6. The carrying value of Niche's identifiable net assets other than goodwill was $60 million at the date of sale. Kutchen had carried the investment in Niche at cost. The finance director calculated that a gain arose of $2 million on the sale of Niche in the group financial statements being the sale proceeds of $50 million less $48 million being their share of the identifiable net assets at the date of sale (80% of $60 million). This was credited to retained earnings.

Business segment restructure

Kutchen has decided to restructure one of its business segments. The plan was agreed by the board of directors on 1 October 20X6 and affects employees in two locations. In the first location, half of the factory units have been closed by 31 December 20X6 and the affected employees' pension benefits have been frozen. Any new employees will not be eligible to join the defined benefit plan. After the restructuring, the present value of the defined benefit obligation in this location is $8 million. The following table relates to location 1.

	Location 1 – $m
Value before restructuring:	
Present value of defined benefit obligation	(10)
Fair value of plan assets	7
Net pension liability	(3)

In the second location, all activities have been discontinued. It has been agreed that employees will receive a payment of $4 million in exchange for the pension liability of $2·4 million in the unfunded pension scheme.

Kutchen estimates that the costs of the above restructuring excluding pension costs will be $6 million. Kutchen has not accounted for the effects of the restructuring in its financial statements because it is planning a rights issue and does not wish to depress the share price. Therefore there has been no formal announcement of the restructuring.

Subsequent acquisition of 20% of Mach

When Kutchen acquired the majority shareholding in Mach, there was an option on the remaining 20% non-controlling interest (NCI), which could be exercised at any time up to 31 March 20X7. On 31 January 20X7, Kutchen acquired the remaining NCI in Mach. The payment for the NCI was structured so that it contained a fixed initial payment and a series of contingent amounts payable over the following two years.

The contingent payments were to be based on the future profits of Mach up to a maximum amount. Kutchen felt that the fixed initial payment was an equity transaction. Additionally, Kutchen was unsure as to whether the contingent payments were either equity, financial liabilities or contingent liabilities.

After a board discussion which contained disagreement as to the accounting treatment, Kutchen is preparing to disclose the contingent payments in accordance with IAS® 37 *Provisions, Contingent Liabilities and Contingent Assets*. The disclosure will include the estimated timing of the payments and the directors' estimate of the amounts to be settled.

Required:

(a) (i) **Explain to the directors of Kutchen, with suitable workings, how goodwill should have been calculated on the acquisition of House and Mach showing the adjustments which need to be made to the consolidated financial statements to correct any errors by the finance director.** (10 marks)

(ii) **Explain, with suitable calculations, how the gain or loss on the sale of Niche should have been recorded in the group financial statements.** (5 marks)

(iii) **Discuss, with suitable workings, how the pension scheme should be dealt with after the restructuring of the business segment and whether a provision for restructuring should have been made in the financial statements for the year ended 31 December 20X6.** (7 marks)

Note: Marks will be allocated in (a) for a suitable discussion of the principles involved as well as the accounting treatment.

(b) **Advise Kutchen on the difference between equity and liabilities, and on the proposed accounting treatment of the contingent payments on the subsequent acquisition of 20% of Mach.** (8 marks)

(30 marks)

2 Abby is a company which conducts business in several parts of the world.

Related party transactions

The accountant has discovered that the finance director of Abby has purchased goods from a company, Arwight, which the director jointly owns with his wife and the accountant believes that this purchase should be disclosed. However, the director refuses to disclose the transaction as in his opinion it is an 'arm's length' transaction. He feels that if the transaction is disclosed, it will be harmful to business and feels that the information asymmetry caused by such non-disclosure is irrelevant as most entities undertake related party transactions without disclosing them. Similarly, the director felt that competitive harm would occur if disclosure of operating segment profit or loss was made. As a result, the entity only disclosed a measure of total assets and total liabilities for each reportable segment.

When preparing the financial statements for the recent year end, the accountant noticed that Arwight has not paid an invoice for several million dollars and it is significantly overdue for payment. It appears that the entity has liquidity problems and it is unlikely that Arwight will pay. The accountant believes that a loss allowance for trade receivables is required. The finance director has refused to make such an allowance and has told the accountant that the issue must not be discussed with anyone within the trade because of possible repercussions for the credit worthiness of Arwight.

Subsidiary fair value adjustments

Additionally, when completing the consolidated financial statements, the director has suggested that there should be no positive fair value adjustments for a recently acquired subsidiary and has stated that the accountant's current position is dependent upon following these instructions. The fair value of the subsidiary is $50 million above the carrying amount in the financial records. The reason given for not fair valuing the subsidiary's net assets is that goodwill is an arbitrary calculation which is meaningless in the context of the performance evaluation of an entity.

Goodwill impairment calculation

Finally, when preparing the annual impairment tests of goodwill arising on other subsidiaries, the director has suggested that the accountant is flexible in the assumptions used in calculating future expected cash flows, so that no impairment of goodwill arises and that the accountant should use a discount rate which reflects risks for which future cash flows have been adjusted. He has indicated that he will support a salary increase for the accountant if he follows his suggestions.

Required:

Discuss the ethical and accounting implications of the above situations from the perspective of the reporting accountant. (18 marks)

Professional marks will be awarded in question 2 for the application of ethical principles. (2 marks)

(20 marks)

Section B – BOTH questions are compulsory and MUST be attempted

3 **(a)** The Dabey Group is a UK group of companies, which owns and operates a social media site on which the public can post material relating to any particular topic. The cost of setting up the site was $3 million. The company generates revenue by selling advertising space on the site. The domain name is protected legally through registration with the national authority.

Dabey has developed good customer relationships with the advertisers and expects them to continue to trade with Dabey. There are no contracts with those advertising customers. Dabey also uses the site to sell transferable domain names which it has purchased from the national regulator. Dabey owns the names and allows purchasers of the names to use the name for a period of five years before it reverts back to Dabey. Dabey expects to achieve an 80% margin on the sale of the domain names.

Required:

(i) Advise Dabey on whether the above items should be accounted for as intangible assets under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. Your answer should discuss the key differences between accounting for the recognition of intangible assets other than goodwill under IAS 38 *Intangible Assets* and FRS 102. (8 marks)

The Dabey Group is diverse in nature and includes a subsidiary which has suffered significant losses during the year. The directors of Dabey have decided to exclude the subsidiary from consolidation on the grounds that it would have a significant effect upon the group's reported earnings. In addition, they intend to show a material deferred tax asset in the group financial statements which was based upon the losses made by the subsidiary in the current year's financial statements.

Required:

(ii) Advise the directors of Dabey as regards the regulations governing the exclusion of subsidiaries from consolidation under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and the Companies Act 2006.

(iii) Discuss the difference between FRS 102 and IAS 12 *Income Tax* in accounting for deferred taxation. Your answer should advise the directors of Dabey as regards the acceptability of recognising the deferred tax asset in the group financial statements. (7 marks)

(b) Africant is about to hold its annual general meeting with shareholders and the directors wish to prepare for any potential questions which may be raised at the meeting. There have been discussions in the media over the fact that the most relevant measurement method should be selected for each category of assets and liabilities. This 'mixed measurement approach' is used by many entities when preparing financial statements. There have also been comments in the media about the impact that measurement uncertainty and price volatility can have on the quality of financial information.

Required:

Discuss the impact which the above matters may have on the analysis of financial statements by investors in Africant. (8 marks)

Professional marks will be awarded in part (b) for clarity and quality of presentation. (2 marks)

(25 marks)

4 The directors of Rationale are reviewing the published financial statements of the group. The following is an extract of information to be found in the financial statements.

Year ended		31 December 20X6 ($m)	31 December 20X5 ($m)
Net profit/(loss) before taxation and after the items set out below		(5)	38
Net interest expense		10	4
Depreciation		9	8
Amortisation of intangible assets		3	2
Impairment of property	10		
Insurance proceeds	(7)	3	
Debt issue costs		2	
Share-based payment		3	1
Restructuring charges		4	
Impairment of acquired intangible assets		6	8

The directors use 'underlying profit' to comment on its financial performance. Underlying profit is a measure normally based on earnings before interest, tax, depreciation and amortisation (EBITDA). However, the effects of events which are not part of the usual business activity are also excluded when evaluating performance.

The following items were excluded from net profit to arrive at 'underlying profit'. In 20X6, the entity had to write off a property due to subsidence and the insurance proceeds recovered for this property was recorded but not approved until 20X7, when the company's insurer concluded that the claim was valid. In 20X6, the entity considered issuing loan notes to finance an asset purchase, however, the purchase did not go ahead. The entity incurred costs associated with the potential issue and so these costs were expensed as part of net profit before taxation. The entity felt that the share-based payment was not a cash expense and that the value of the options was subjective. Therefore, the directors wished to exclude the item from 'underlying profit'. Similarly, the directors wish to exclude restructuring charges incurred in the year, and impairments of acquired intangible assets.

Required:

(a) (i) Discuss the possible concerns where an entity may wish to disclose additional information in its financial statements and whether the Exposure Draft on the Conceptual Framework for Financial Reporting® helps in determining the boundaries for disclosure. (8 marks)

(ii) Discuss the use and the limitations of the proposed calculation of 'underlying profit' by Rationale.

Note: Your answer should include a comparative calculation of underlying profit for the years ended 31 December 20X5 and 20X6. (9 marks)

(b) The directors of Rationale are confused over the nature of a reclassification adjustment and understand that the IASB has issued pronouncements on the subject.

Required:

Discuss, with examples, the nature of a reclassification adjustment and the arguments for and against allowing reclassification of items to profit or loss.

Note: A brief reference should be made in your answer to the IASB's Exposure Draft on the Conceptual Framework. (8 marks)

(25 marks)

End of Question Paper

Answers

1 (a) (i) Goodwill on the acquisition of House and Mach should have been calculated as follows:

House

	$m	$m
Fair value of consideration for 70% interest	42	
Fair value of non-controlling interest	16·38	58·38
Fair value of identifiable net assets acquired		(48)
Goodwill		10·38

Contingent consideration should be valued at fair value and will have to take into account the various milestones set under the agreement. The expected value is (20% x 5 million shares) 1 million shares x $2, i.e. $2 million. There will be no remeasurement of the fair value in subsequent periods. If this were a liability, there would be remeasurement. The contingent consideration will be shown in OCE. The fair value of the consideration is therefore 20 million shares at $2 plus $2 million (above), i.e. $42 million.

The fair value of the NCI is 30% x 13 million x $4·20 = $16·38 million.

The finance director has not taken into account the fair value of the NCI in the valuation of goodwill or the contingent consideration. If the difference between the fair value of the consideration, NCI and the identifiable net assets is negative, the resulting gain is a bargain purchase in profit or loss, which may arise in circumstances such as a forced seller acting under compulsion. However, before any bargain purchase gain is recognised in profit or loss, and hence in retained earnings in the group statement of financial position, the finance director should have undertaken a review to ensure the identification of assets and liabilities is complete, and that measurements appropriately reflect consideration of all available information.

The adjustment to the group financial statements would be as follows:

Dr Goodwill	$10·38 million
Dr Profit or loss	$8 million
Cr NCI	$16·38 million
Cr OCE	$2 million

Mach

Net profit of Mach for the year to 31 December 20X5 is $3·6 million. The P/E ratio (adjusted) is 19. Therefore the fair value of Mach is 19 x $3·6 million, i.e. $68·4 million. The NCI has a 20% holding; therefore the fair value of the NCI is $13·68 million.

	$m	$m
Fair value of consideration for 80% interest ($52m + $5m)	57	
Fair value of non-controlling interest	13·68	70·68
Fair value of identifiable net assets acquired		(55)
Goodwill		15·68

The land transferred as part of the purchase consideration should be valued at its acquisition date fair value of $5 million and included in the goodwill calculation. Therefore the increase of $2 million over the carrying amount should be shown in retained earnings.

Dr PPE	$2 million
Cr Retained earnings	$2 million

The adjustment to the group financial statements would be as follows:

Dr Goodwill	$15·68 million
Dr Retained earnings	$3 million
Cr NCI	$13·68 million
Cr PPE	$5 million

Total goodwill is therefore $(15·68 + 10·38) million, i.e. $26·06 million.

(ii) Niche

The finance director had calculated that a gain arose of $2 million on the sale of Niche in the group financial statements being the sale proceeds of $50 million less $48 million which is their share of the identifiable net assets at the date of sale (80% of $60 million). However, the calculation of the gain or loss on sale should have been the difference between the carrying amount of the net assets (including any unimpaired goodwill) disposed of and any proceeds received. The calculation of net assets will include the appropriate portion of cumulative exchange differences and any other amounts recognised in other comprehensive income and accumulated in equity. Additionally, the loss on sale should have been reported as a loss in profit or loss attributable to the parent.

The gain on the sale of Niche should have been recorded as follows:

	$m
Gain/(Loss) in group financial statements on sale of Niche	
Sale proceeds	50
Less	
Share of identifiable net assets at date of disposal (80% x $60 million)	(48)
Goodwill $(40m – (80% of $44m) – impairment $2m)	(2·8)
Loss on sale of Niche recognised in group profit or loss	(0·8)

(iii) After restructuring, the present value of the pension liability in location 1 is reduced to $8 million. Thus there will be a negative past service cost in this location of $(10 – 8) million, i.e. $2 million. As regards location 2, there is a settlement and a curtailment as all liability will be extinguished by the payment of $4 million. Therefore there is a loss of $(2·4 – 4) million, i.e. $1·6 million. The changes to the pension scheme in locations 1 and 2 will both affect profit or loss as follows:

Location 1

Dr Pension obligation	$2m
Cr Retained earnings	$2m

Location 2

Dr Pension obligation	$2·4m
Dr Retained earnings	$1·6m
Cr Current liabilities	$4m

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that a provision for restructuring should be made only when a detailed formal plan is in place and the entity has started to implement the plan, or announced its main features to those affected. A board decision is insufficient. Even though there has been no formal announcement of the restructuring, Kutchen has started implementing it and therefore it must be accounted for under IAS 37.

A provision of $6 million should also be made at the year end.

(b) The Framework defines a liability as a present obligation, arising from past events and there is an expected outflow of economic benefits. IAS 32 *Financial Instruments: Presentation* establishes principles for presenting financial instruments as liabilities or equity. IAS 32 does not classify a financial instrument as equity or financial liability on the basis of its legal form but on the substance of the transaction. The key feature of a financial liability is that the issuer is obliged to deliver either cash or another financial asset to the holder. An obligation may arise from a requirement to repay principal or interest or dividends.

In contrast, equity has a residual interest in the entity's assets after deducting all of its liabilities. An equity instrument includes no obligation to deliver cash or another financial asset to another entity. A contract which will be settled by the entity receiving or delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. However, if there is any variability in the amount of cash or own equity instruments which will be delivered or received, then such a contract is a financial asset or liability as applicable.

The contingent payments should not be treated as contingent liabilities but they should be recognised as financial liabilities and measured at fair value at initial recognition. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* excludes from its scope contracts which are executory in nature, and therefore prevents the recognition of a liability. Additionally, there is no onerous contract in this scenario.

Contingent consideration for a business must be recognised at the time of acquisition, in accordance with IFRS® 3 *Business Combinations*. However, IFRS do not contain any guidance when accounting for contingent consideration for the acquisition of a NCI in a subsidiary. The contract for contingent payments does meet the definition of a financial liability under IAS 32. Kutchen has an obligation to pay cash to the vendor of the NCI under the terms of a contract. It is not within Kutchen's control to be able to avoid that obligation. The amount of the contingent payments depends on the profitability of Mach, which itself depends on a number of factors which are uncontrollable. IAS 32 states that a contingent obligation to pay cash which is outside the control of both parties to a contract meets the definition of a financial liability which shall be initially measured at fair value. Since the contingent payments relate to the acquisition of the NCI, the offsetting entry would be recognised directly in equity.

2 The objective of IAS 24 *Related Party Disclosures* is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties. If there have been transactions between related parties, there should be disclosure of the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. The director is a member of the key management personnel of the reporting entity and the entity from whom the goods were purchased is jointly controlled by that director. Therefore a related party relationship exists and should be disclosed.

IFRS 8 *Operating Segments* requires an entity to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments which meet specified criteria. IFRS 8 does not

contain a 'competitive harm' exemption and requires entities to disclose the financial information which is provided by the chief operating decision maker (CODM). The management accounts reviewed by the CODM may contain commercially sensitive information, and IFRS 8 might require that information to be disclosed externally. Under IFRS 8, firms should provide financial segment disclosures which enable investors to assess the different sources of risk and income as management does. This sensitive information would also be available for competitors. The potential competitive harm may encourage firms to withhold segment information. However, this is contrary to IFRS 8 which requires information about the profit or loss for each reportable segment, including certain specified revenues and expenses such as revenue from external customers and from transactions with other segments, interest revenue and expense, depreciation and amortisation, income tax expense or income and material non-cash items.

Areas such as impairments of financial assets often involve the application of professional judgement. The director may have received additional information, which has allowed him to form a different opinion to that of the accountant. The matter should be discussed with the director to ascertain why no provision is required and to ask whether there is additional information available. However, suspicion is raised by the fact that the accountant has been told not to discuss the matter. Whilst there may be valid reasons for this, it appears again that the related party relationship is affecting the judgement of the director.

Positive fair value adjustments increase the assets of the acquired company and as such reduce the goodwill recognised on consolidation. However, the majority of positive fair value adjustments usually relate to items of property, plant and equipment. As a result, extra depreciation based on the net fair value adjustment reduces the post-acquisition profits of the subsidiary. This has a negative impact on important financial performance measures such as EPS. Therefore, by reducing fair value adjustments it will improve the apparent performance of new acquisitions and the consolidated financial statements. Accountants should act ethically and ignore undue pressure to undertake creative accounting in preparing such adjustments. Guidance such as IFRS 3 *Business Combinations* and IFRS 13 *Fair Value Measurement* should be used in preparing adjustments and professional valuers should be engaged where necessary.

In measuring value in use, the discount rate used should be the pre-tax rate which reflects current market assessments of the time value of money and the risks specific to the asset. The discount rate should not reflect risks for which future cash flows have been adjusted and should equal the rate of return which investors would require if they were to choose an investment which would generate cash flows equivalent to those expected from the asset. By reducing the impairment, it would have a positive impact on the financial statements. The offer of a salary increase is inappropriate and no action should be taken until the situation is clarified. Inappropriate financial reporting raises issues and risks for those involved and others associated with the company. Whilst financial reporting involves judgement, it would appear that this situation is related to judgement.

There are several potential breaches of accounting standards and unethical practices being used by the director. The director is trying to coerce the accountant into acting unethically. IAS 1 *Presentation of Financial Statements* requires all standards to be applied if fair presentation is to be obtained. Directors cannot choose which standards they do or do not apply. It is important that accountants identify issues of unethical practice and act appropriately in accordance with ACCA's *Codes of Ethics*. The accountant should discuss the matters with the director. The technical issues should be explained and the risks of non-compliance explained to the director. If the director refuses to comply with accounting standards, then it would be appropriate to discuss the matter with others affected such as other directors and seek professional advice from ACCA. Legal advice should be considered if necessary.

An accountant who comes under pressure from senior colleagues to make inappropriate valuations and disclosures should discuss the matter with the person suggesting this. The discussion should try to confirm the facts and the reporting guidance which needs to be followed. Financial reporting does involve judgement but the cases above seem to be more than just differences in opinion. The accountant should keep a record of conversations and actions and discuss the matters with others affected by the decision, such as directors. Additionally, resignation should be considered if the matters cannot be satisfactorily resolved.

3 (a) (i) FRS 102 permits an entity to recognise an intangible asset when it is probable that the entity will receive the expected future economic benefits attributable to the asset, and its cost or value can be measured reliably. This requirement applies whether an intangible asset is acquired externally or generated internally. The price which an entity pays to acquire an intangible asset reflects its expectations about the probability that the expected future economic benefits in the asset will flow to the entity.

The effect of probability is reflected in the cost of the asset and the probability recognition criterion above is always considered to be satisfied for separately acquired intangible assets. The cost of a separately acquired intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

The social media site is an intangible asset of the entity. It is an asset of the entity because the entity has control through ownership of the website and expects to generate future economic benefits by selling advertising space on the site. Also, the cost of setting up the site can be measured reliably. In the absence of legal rights to protect the entity's relationships with its customers or to control the customers' loyalty, Dabey is unlikely to have sufficient control over the expected economic benefits from its customer relationships to meet the definition of an intangible asset. Legal rights to protect customer relationships provide evidence that the entity is able to control the expected future economic benefits flowing from the customer relationships. When an entity establishes relationships with its customers through fixed-term contracts, and those contracts contain legally enforceable contractual rights to future revenue, the definition of an intangible asset will be met. However, internally generated intangible assets are not recognised but separately acquired customer lists may qualify for recognition. Although each domain name satisfies the definition of an intangible asset, the names are not classified as intangible assets of the entity. The domain names are inventories of the entity because they are assets held for sale in the ordinary course of business.

Under FRS 102, an entity may recognise an intangible asset arising from development if, and only if, an entity can demonstrate several criteria have been met such as the technical feasibility of completing the intangible asset and the entity's intention to complete the intangible asset and use or sell it. Where an entity adopts a policy of capitalising expenditure in the development phase which meets the conditions in FRS 102, that policy should be applied consistently to all expenditure which meets the requirements for capitalisation. Thus in FRS 102, the capitalisation of development expenditure is optional whereas, in contrast, IAS 38 *Intangible Assets* requires that development expenditure is capitalised if the criteria are met.

FRS 102 states that all intangible assets should be considered to have a finite useful life. The useful life of an intangible asset which arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If, in exceptional cases, an entity is unable to make a reliable estimate of the useful life of an intangible asset, the life shall not exceed ten years. FRS 102 specifies that intangible assets should be considered to have a definite useful life. FRS 102 states that if the useful life of an intangible asset cannot be measured reliably, then it must be estimated. The estimate used should not exceed ten years. IAS 38 allows entities to regard an intangible asset as having an indefinite useful life if it cannot foresee an end to the period over which the asset will generate economic benefits.

FRS 102 specifies that an intangible asset acquired by way of a grant shall be recognised at its fair value on the date that the grant is received or receivable. IAS 38 states that there is a choice of recognition at fair value or at the nominal value of the grant. In addition, an intangible asset acquired in a business combination can be treated differently in accordance with FRS 102.

(ii) FRS 102 states that a subsidiary cannot be excluded from consolidation merely because its business activities are dissimilar to those of the other entities within the consolidation, or because the information necessary for the preparation of consolidated financial statements cannot be obtained without disproportionate expense or undue delay, unless its inclusion is not material. However, s.405 of the Companies Act allows this latter exclusion. FRS 102 states that it cannot justify this exemption, and so it effectively prevents the statutory option.

However, a subsidiary shall be excluded from consolidation where:

(a) severe long-term restrictions substantially hinder the exercise of the rights of the parent over the assets or management of the subsidiary; or

(b) the interest in the subsidiary is held exclusively with a view to subsequent resale; and the subsidiary has not previously been consolidated in the consolidated financial statements prepared in accordance with this FRS.

Thus, the directors of Dabey cannot exclude the subsidiary on the basis of it being loss making and having an effect on the earnings of the group.

(iii) The income tax section of FRS 102 differs significantly from IAS 12 *Income Taxes*. FRS 102 bases its approach to the recognition of deferred tax on timing differences which are differences between taxable profits and total comprehensive income as stated in the financial statements arising from the inclusion of income and expenses in tax assessments in periods different from those in which they are recognised in financial statements.

In contrast, IAS 12 states that deferred tax should be accounted for based on differences between the amounts recognised for the entity's assets and liabilities in the statement of financial position and the recognition of those assets and liabilities by the tax authorities.

FRS 102 uses the concept of permanent differences. Permanent differences arise because certain types of income and expenses are non-taxable or disallowable, or because certain tax charges or allowances are greater or smaller than the corresponding income or expense in the financial statements. Deferred tax is not recognised on permanent differences under IAS 12 and IAS 12 does not use the terminology 'permanent difference'. Instead, it states that deferred tax assets and liabilities are recognised for 'temporary differences'.

Unrelieved tax losses and other deferred tax assets are recognised only to the extent that it is probable that they will be recovered against the reversal of deferred tax liabilities or other future taxable profits. The very existence of unrelieved tax losses is strong evidence that there may not be other future taxable profits against which the losses will be relieved. Under IAS 12, an entity recognises a deferred tax for deductible temporary differences, unused tax losses and unused tax credits to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised.

Thus, the directors of Dabey cannot recognise a deferred tax asset purely because the subsidiary is loss making. A justification for the deferred tax asset must be made on the basis of the criteria set out in FRS 102.

(b) Some investors might argue in favour of a single measurement basis for all recognised assets and liabilities as the resulting totals and subtotals can have little meaning if different measurement methods are used. Similarly, profit or loss may lack relevance if it reflects a combination of flows based on historical cost and of value changes for items measured on a current value basis.

However, the majority of investors would tend to favour a mixed measurement approach, whereby the most relevant measurement method is selected for each category of assets and liabilities. This approach is consistent with how investors analyse financial statements. The problems of mixed measurement are outweighed by the greater relevance achieved if the most relevant measurement basis is used for each class of assets and liabilities. The mixed measurement approach is reflected in recent standards; for example, IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*.

Historical cost would not have been relevant for all financial assets and has severe limitations for many liabilities; hence, the only viable single measurement method would have been fair value.

IFRS 9 requires the use of cost in some cases and fair value in other cases, while IFRS 15 essentially applies cost allocation. The draft Conceptual Framework does not propose a single measurement method for all assets and liabilities, and instead supports the continued use of a mixed measurement approach.

Most accounting measures of assets and liabilities are uncertain and require estimation. While some measures of historical cost are straightforward as it is the amount paid or received, there are many occasions when the measurement of cost can be uncertain – particularly recoverable cost, for which impairment and depreciation estimates are required. In a similar vein, while some measures of fair value can be easily observed because of the availability of prices in an actively traded market (a so-called 'Level 1' fair value), others inevitably rely on management estimates and judgements ('Level 2' and 'Level 3').

High measurement uncertainty might reduce the quality of information available to investors. High price volatility may make analysing an investment in that entity more challenging. If a relevant measure of an asset or liability value is volatile, this should not be hidden from investors. To conceal its volatility would decrease the usefulness of the financial statements. Of course, such volatile gains and losses do need to be clearly presented and disclosed, because their predictive value may differ from that provided by other components of performance.

4 (a) (i) There is no specific guidance on information which is not required by an IFRS being disclosed in financial statements. IFRS requires an entity to disclose additional information which is relevant to an understanding of the entity's financial position and financial performance.

A company may disclose additional information where it is felt that an entity's performance may not be apparent from accounts prepared under IFRS. A single standardised set of accounting practices can never be sufficient information to understand an entity's position or performance. Additional information can help users understand management's view of what is important to the entity and the nature of management's decisions.

There are concerns relating to the disclosure of additional information. Such information may not readily be derived or reconciled back to financial statements. There is also difficulty comparing information across periods and between entities because of the lack of standardised approaches. Also the presentation of additional information may be inconsistent with that defined or specified in IFRS and the entity may present an excessively optimistic picture of an entity's financial performance. Non-IFRS information may make it difficult to identify the complete set of financial statements, including whether the information is audited or not. Additionally, the information may be given undue prominence or credibility merely because of its location within the financial statements. Non-IFRS financial information should be clearly labelled in a way that distinguishes it from the corresponding IFRS financial information. Any term used to describe the information should be appropriate having regard to the nature of the information. The term or label should not cause confusion with IFRS information and should accurately describe the measure.

Disclosure boundaries are not specifically defined in IFRS, but they do derive from the objective of financial statements. According to the proposals in the ongoing Conceptual Framework project, the objective of financial statements is to provide information about an entity's assets, liabilities, equity, income and expenses which is useful to users of financial statements in assessing the prospects for future net cash inflows to the entity and in assessing management's stewardship of the entity's resources. As a result, financial statements provide information about an entity's assets, liabilities and equity which existed at the end of or during the reporting period and about income and expenses which arose during the reporting period. It is directed at users who provide resources to the reporting entity but lack the ability to compel the entity to provide them with the information which they need. The revised Framework limits the range of addressees of general-purpose financial statements to existing or potential investors, lenders and other creditors. The revised Framework continues to acknowledge that general purpose financial statements may not provide information which serves all users' needs.

(ii) The directors of Rationale are utilising a controversial figure for evaluating a company's earnings. Depreciation and amortisation are non-cash expenses related to assets which have already been purchased and they are expenses which are subject to judgement or estimates based on experience and projections. The company, by using EBITDA, is attempting to show operating cash flow since the non-cash expenses are added back.

However, EBITDA can also be misused and manipulated. It can be argued that because the estimation of depreciation, amortisation and other non-cash items is vulnerable to judgement error, the profit figure can be distorted but by focusing on profits before these elements are deducted, a truer estimation of cash flow can be given. However, the substitution of EBITDA for conventional profit fails to take into account the need for investment in fixed capital items.

There can be an argument for excluding non-recurring items from the net profit figure. Therefore, it is understandable that the deductions for the impairment of property, the insurance recovery and the debt issue costs are made to arrive at 'underlying profit'. However, IAS 1 *Presentation of Financial Statements* states 'An entity shall present additional line items, headings and subtotals in the statements presenting profit and loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.' This paragraph should not be used to justify presentation of underlying, adjusted and pre-exceptional measures of performance on the face of the income statement. The measures proposed are entity specific and could obscure performance and poor management.

Share-based compensation may not represent cash but if an entity chooses to pay equity to an employee, that affects the value of equity, no matter what form that payment is in and therefore it should be charged as employee compensation. It is an outlay in the form of equity. There is therefore little justification in excluding this expense from net profit. Restructuring charges are a feature of an entity's business and they can be volatile. They should not be excluded from net profit because they are part of corporate life. Severance costs and legal fees are not non-cash items.

Impairments of acquired intangible assets usually reflect a weaker outlook for an acquired business than was expected at the time of the acquisition, and could be considered to be non-recurring. However, the impairment charges are a useful way of holding management accountable for its acquisitions. In this case, it seems as though Rationale has not purchased wisely in 20X6.

It appears as though Rationale wishes to disguise a weak performance in 20X6 by adding back a series of expense items. EBITDA, although reduced significantly from 20X5, is now a positive figure and there is an underlying profit created as opposed to a loss. However, users will still be faced with a significant decline in profit whichever measure is disclosed by Rationale. The logic for the increase in profit is flawed in many cases but there is a lack of authoritative guidance in the area. Many companies adopt non-financial measures without articulating the relationship between the measures and the financial statements.

Year ended	31 December 20X6 ($m)	31 December 20X5 ($m)
Net profit/(loss) before taxation and after the items set out below	(5)	38
Net interest expense	10	4
Depreciation	9	8
Amortisation of intangible assets	3	2
EBITDA	17	52
Impairment of property	10	
Insurance recovery	(7)	–
Debt issue costs	2	
EBITDA after non-recurring items	22	52
Share-based payment	3	1
Restructuring charges	4	
Impairment of acquired intangible assets	6	8
Underlying profit	35	61

(b) Reclassification adjustments are amounts recycled to profit or loss in the current period which were recognised in OCI in the current or previous periods. An example of items recognised in OCI which may be reclassified to profit or loss are foreign currency gains on the disposal of a foreign operation and realised gains or losses on cash flow hedges. Those items which may not be reclassified are changes in a revaluation surplus under IAS 16 *Property, Plant and Equipment*, and actuarial gains and losses on a defined benefit plan under IAS 19 *Employee Benefits*. However, there is a general lack of agreement about which items should be presented in profit or loss and in OCI. The interaction between profit or loss and OCI is unclear, especially the notion of reclassification and when or which OCI items should be reclassified. A common misunderstanding is that the distinction is based upon realised versus unrealised gains.

There are several arguments for and against reclassification. If reclassification ceased, then there would be no need to define profit or loss, or any other total or subtotal in profit or loss, and any presentation decisions can be left to specific IFRSs. It is argued that reclassification protects the integrity of profit or loss and provides users with relevant information about a transaction which occurred in the period. Additionally, it can improve comparability where IFRS permits similar items to be recognised in either profit or loss or OCI.

Those against reclassification argue that the recycled amounts add to the complexity of financial reporting, may lead to earnings management and the reclassification adjustments may not meet the definitions of income or expense in the period as the change in the asset or liability may have occurred in a previous period.

The lack of a consistent basis for determining how items should be presented has led to an inconsistent use of OCI in IFRS. Opinions vary but there is a feeling that OCI has become a home for anything controversial because of a lack of clear definition of what should be included in the statement. Many users are thought to ignore OCI, as the changes reported are not caused by the operating flows used for predictive purposes.

The ED states that it is not feasible to attempt to define in the Conceptual Framework when an item of income or expense should be included in the statement of profit or loss or OCI. Instead, high level guidance on reclassification has been included. The ED proposes that there is a presumption that if income and expenses are included in OCI in one period, they will be reclassified in some future period when including the income in the statement of profit or loss enhances the relevance of the information in that period. The presumption can be rebutted if there is no clear basis for identifying the period in which the reclassification would enhance the relevance of the information in the statement of profit or loss. This may indicate that the income or expense should not have been included in OCI originally. It can be argued that reclassification adjustments do not meet the definition of income and expenses in the period they occur and that, therefore, the IASB should acknowledge in the Conceptual Framework those adjustments as items of the statement(s) of performance which do not fulfil the definition of income and expense.

				Marks	*Marks*
1	**(a)**	**(i)**	– application of the following discussion to the scenario:		
			contingent consideration	2	
			NCI	2	
			fair value of assets acquired	2	
			– goodwill calculations and corrections required	4	10
		(ii)	– application of the following discussion to the scenario:		
			proceeds	1	
			carrying amount of the assets disposed of	2	
			– calculation of the gain/loss on disposal of Niche	2	5
		(iii)	– application of the following discussion to the scenario:		
			present value and past service cost	2	
			– calculation of SOPL effect	3	
			– consideration of a restructuring provision	2	7
	(b)		– application of the following discussion to the scenario:		
			definition of a liability and IAS 32 (liability v equity)	2	
			definition of equity	2	
			consideration of contingent payments of Mach	4	8
					30
2			– application of the following discussion of accounting issues to the scenario:		
			related party transactions	2	
			competitive harm exemptions	2	
			impairment of financial assets	2	
			fair value adjustments	2	
			goodwill impairment review	2	
			– application of the following discussion of ethical issues to the scenario:		
			potential breaches	4	
			advice to accountant	4	18
			Professional		2
					20
3	**(a)**	**(i)**	– recognition criteria of FRS 102	2	
			– application of the FRS 102 reognition criteria to Dabey's intangibles	3	
			– comparison of FRS 102 to IAS 38	3	8
		(ii)	– the exlusion of a subsidiary per FRS 102		3
		(iii)	– FRS 102 v IAS 12 re deferred tax	3	
			– application of FRS 102 to DT of Dabey	1	4
	(b)		– single v mixed measurement and investor issues	2	
			– examples	2	
			– investor issues re uncertainty	2	
			– investor issues re price volatility	2	8
			Professional		2
					25

				Marks	*Marks*
4	**(a)**	**(i)**	– additional disclosure issues	4	
			– Conceptual Framework ED and general financial statements	4	8
		(ii)	– the potential use, misuse and manipulation of EBITDA	3	
			– application of use/misuse of EBITDA by Rationale	2	
			– calculation of underlying profit of Rationale	4	9
	(b)		– the nature of a reclassification adjustment	1	
			– examples	2	
			– arguments for and against reclassification	5	8
					25