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Strategic Professional – Essentials

Strategic Business Reporting – International

Specimen Exam 2 applicable from September 2018

SBR INT ACCA

Paper SBR – INT

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

Section A – BOTH questions are compulsory and MUST be attempted

1 Background

Hill is a public limited company which has investments in a number of other entities. All of these entities prepare their financial statements in accordance with International Financial Reporting Standards. Extracts from the draft individual statements of profit or loss for Hill, Chandler and Doyle for the year ended 30 September 20X6 are presented below.

	Hill	Chandler	Doyle
	$m	$m	$m
Profit/(loss) before taxation	(45)	67	154
Taxation	9	(15)	(31)
Profit/(loss) for the period	(36)	52	123

Acquisition of 80% of Chandler

Hill purchased 80% of the ordinary shares of Chandler on 1 October 20X5. Cash consideration of $150 million has been included when calculating goodwill in the consolidated financial statements. The purchase agreement specified that a further cash payment of $32 million becomes payable on 1 October 20X7 but no entries have been posted in the consolidated financial statements in respect of this. A discount rate of 5% should be used.

In the goodwill calculation, the fair value of Chandler's identifiable net assets was deemed to be $170 million. Of this, $30 million related to Chandler's non-depreciable land. However, on 31 December 20X5, a survey was received which revealed that the fair value of this land was actually only $20 million as at the acquisition date. No adjustments have been made to the goodwill calculation in respect of the results of the survey. The non-controlling interest at acquisition was measured using the proportionate method as $34 million ($170m x 20%).

As at 30 September 20X6, the recoverable amount of Chandler was calculated as $250 million. No impairment has been calculated or accounted for in the consolidated financial statements.

Disposal of 20% holding in Doyle

On 1 October 20X4, Hill purchased 60% of the ordinary shares of Doyle. At this date, the fair value of Doyle's identifiable net assets was $510 million. The non-controlling interest at acquisition was measured at its fair value of $215 million. Goodwill arising on the acquisition of Doyle was $50 million and had not been impaired prior to the disposal date. On 1 April 20X6, Hill disposed of a 20% holding in the shares of Doyle for cash consideration of $140 million. At this date, the net assets of Doyle, excluding goodwill, were carried in the consolidated financial statements at $590 million.

From 1 April 20X6, Hill has the ability to appoint two of the six members of Doyle's board of directors. The fair value of Hill's 40% shareholding was $300 million at that date.

Issue of convertible bond

On 1 October 20X5, Hill issued a convertible bond at par value of $20 million and has recorded it as a non-current liability. The bond is redeemable for cash on 30 September 20X7 at par. Bondholders can instead opt for conversion in the form of a fixed number of shares. Interest on the bond is payable at a rate of 4% a year in arrears. The interest paid in the year has been presented in finance costs. The interest rate on similar debt without a conversion option is 10%.

Discount factors

Year	Discount rate 5%	Discount rate 10%
1	0·952	0·909
2	0·907	0·826

Required:

(a) (i) In respect of the investment in Chandler, explain, with suitable calculations, how goodwill should have been calculated, and show the adjustments which need to be made to the consolidated financial statements for this as well as any implications of the recoverable amount calculated at 30 September 20X6. (13 marks)

(ii) Discuss, with suitable calculations, how the investment in Doyle should be dealt with in the consolidated financial statements for the year ended 30 September 20X6. (7 marks)

(iii) Discuss, with suitable calculations, how the convertible bond should be dealt with in the consolidated financial statements for the year ended 30 September 20X6, showing any adjustments required. (6 marks)

(b) Hill has made a loss in the year ended 30 September 20X6, as well as in the previous two financial years. In the consolidated statement of financial position it has recognised a material deferred tax asset in respect of the carry-forward of unused tax losses. These losses cannot be surrendered to other group companies. On 30 September 20X6, Hill breached a covenant attached to a bank loan which is due for repayment in 20X9. The loan is presented in non-current liabilities on the statement of financial position. The loan agreement terms state that a breach in loan covenants entitles the bank to demand immediate repayment of the loan. Hill and its subsidiaries do not have sufficient liquid assets to repay the loan in full. However, on 1 November 20X6 the bank confirmed that repayment of the loan would not be required until the original due date. Hill has produced a business plan which forecasts significant improvement in its financial situation over the next three years as a result of the launch of new products which are currently being developed.

Required:

Discuss the proposed treatment of Hill's deferred tax asset and the financial reporting issues raised by its loan covenant breach. (9 marks)

(35 marks)

2 Gustoso is a public limited company which produces a range of luxury Italian food products which are sold to restaurants, shops and supermarkets. It prepares its financial statements in accordance with International Financial Reporting Standards. The directors of Gustoso receive a cash bonus each year if reported profits for the period exceed a pre-determined target. Gustoso has performed in excess of targets in the year ended 31 December 20X7. Forecasts for 20X8 are, however, pessimistic due to economic uncertainty and stagnant nationwide wage growth.

Provisions

A new accountant has recently started work at Gustoso. She noticed that the provisions balance as at 31 December 20X7 is significantly higher than in the prior year. She made enquiries of the finance director, who explained that the increase was due to substantial changes in food safety and hygiene laws which become effective during 20X8. As a result, Gustoso must retrain a large proportion of its workforce. This retraining has yet to occur, so a provision has been recognised for the estimated cost of $2 million. The finance director then told the accountant that such enquiries were a waste of time and would not be looked at favourably when deciding on her future pay rises and bonuses.

Wheat contract

Gustoso purchases significant quantities of wheat for use in its bread and pasta products. These are high-value products on which Gustoso records significant profit margins. Nonetheless, the price of wheat is volatile and so, on 1 November 20X7, Gustoso entered into a contract with a supplier to purchase 500,000 bushels of wheat in June 20X8 for $5 a bushel. The contract can be settled net in cash. Gustoso has entered into similar contracts in the past and has always taken delivery of the wheat. By 31 December 20X7 the price of wheat had fallen. The finance director recorded a derivative liability of $0·5 million on the statement of financial position and a loss of $0·5 million in the statement of profit or loss. Wheat prices may rise again before June 20X8. The accountant is unsure if the current accounting treatment is correct but feels uncomfortable approaching the finance director again.

Required:

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

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

(15 marks)

Section B – BOTH questions are compulsory and MUST be attempted

3 Calendar has a reporting date of 31 December 20X7. It prepares its financial statements in accordance with International Financial Reporting Standards. Calendar develops biotech products for pharmaceutical companies. These pharmaceutical companies then manufacture and sell the products. Calendar receives stage payments during product development and a share of royalties when the final product is sold to consumers. A new accountant has recently joined Calendar's finance department and has raised a number of queries.

(a) **(i)** During 20X6 Calendar acquired a development project through a business combination and recognised it as an intangible asset. The commercial director decided that the return made from the completion of this specific development project would be sub-optimal. As such, in October 20X7, the project was sold to a competitor. The gain arising on derecognition of the intangible asset was presented as revenue in the financial statements for the year ended 31 December 20X7 on the grounds that development of new products is one of Calendar's ordinary activities. Calendar has made two similar sales of development projects in the past, but none since 20X0.

The accountant requires advice about whether the accounting treatment of this sale is correct. (6 marks)

(ii) While searching for some invoices, the accountant found a contract which Calendar had entered into on 1 January 20X7 with Diary, another entity. The contract allows Calendar to use a specific aircraft owned by Diary for a period of three years. Calendar is required to make annual payments.

On 1 January 20X7, costs were incurred negotiating the contract. The first annual payment was made on 31 December 20X7. Both of these amounts have been expensed to the statement of profit or loss.

There are contractual restrictions concerning where the aircraft can fly. Subject to those restrictions, Calendar determines where and when the aircraft will fly, and the cargo and passengers which will be transported.

Diary is permitted to substitute the aircraft at any time during the three-year period for an alternative model and must replace the aircraft if it is not working. Any substitute aircraft must meet strict interior and exterior specifications outlined in the contract. There are significant costs involved in outfitting an aircraft to meet Calendar's specifications.

The accountant requires advice as to the correct accounting treatment of this contract. (9 marks)

Required:

Advise the accountant on the matters set out above with reference to International Financial Reporting Standards.

Note: The split of the mark allocation is shown against each of the two issues above.

(b) The new accountant has been reviewing Calendar's financial reporting processes. She has recommended the following:

– All purchases of property, plant and equipment below $500 should be written off to profit or loss. The accountant believes that this will significantly reduce the time and cost involved in maintaining detailed financial records and producing the annual financial statements.

– A checklist should be used when finalising the annual financial statements to ensure that all disclosure notes required by specific IFRS and IAS Standards are included.

Required:

With reference to the concept of materiality, discuss the acceptability of the above two proposals.

Note: Your answer should refer to the Exposure Draft on the IFRS Practice Statement: *Application of Materiality to Financial Statements*. (10 marks)

(25 marks)

4 (a) Kiki is a public limited entity. It designs and manufactures children's toys. It has a reporting date of 31 December 20X7 and prepares its financial statements in accordance with International Financial Reporting Standards. The directors require advice about the following situations.

(i) Kiki sells $50 gift cards. These can be used when purchasing any of Kiki's products through its website. The gift cards expire after 12 months. Based on significant past experience, Kiki estimates that its customers will redeem 70% of the value of the gift card and that 30% of the value will expire unused. Kiki has no requirement to remit any unused funds to the customer when the gift card expires unused.

The directors are unsure about how the gift cards should be accounted for. (6 marks)

(ii) Kiki's best-selling range of toys is called Scarimon. In 20X6 Colour, another listed company, entered into a contract with Kiki for the rights to use Scarimon characters and imagery in a monthly comic book. The contract terms state that Colour must pay Kiki a royalty fee for every issue of the comic book which is sold. Before signing the contract, Kiki determined that Colour had a strong credit rating. Throughout 20X6, Colour provided Kiki with monthly sales figures and paid all amounts due in the agreed-upon period. At the beginning of 20X7, Colour experienced cash flow problems. These were expected to be short term. Colour made nominal payments to Kiki in relation to comic sales for the first half of the year. At the beginning of July 20X7, Colour lost access to credit facilities and several major customers. Colour continued to sell Scarimon comics online and through specialist retailers but made no further payments to Kiki.

The directors are unsure how to deal with the above issues in the financial statements for the year ended 31 December 20X7. (6 marks)

Required:

Advise the accountant on the matters set out above with reference to International Financial Reporting Standards.

Note: The split of the mark allocation is shown against each of the two issues above.

(b) As a result of rising property prices, Kiki purchased five buildings during the current period in order to benefit from further capital appreciation. Kiki has never owned an investment property before. In accordance with IAS 40 *Investment Property*, the directors are aware that they can measure the buildings using either the fair value model or the cost model. However, they are concerned about the impact that this choice will have on the analysis of Kiki's financial performance, position and cash flows by current and potential investors.

Required:

Discuss the potential impact which this choice in accounting policy will have on investors' analysis of Kiki's financial statements. Your answer should refer to key financial performance ratios. (11 marks)

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

(25 marks)

End of Question Paper

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Answers

1 (a) (i) Deferred consideration

When calculating goodwill, IFRS 3 *Business Combinations* states that purchase consideration should be measured at fair value. For deferred cash consideration, this will be the present value of the cash flows. This amounts to $29 million ($32m x 0·907). Goodwill arising on acquisition should be increased by $29 million and a corresponding liability should be recognised:

Dr Goodwill	$29 million
Cr Liability	$29 million

Interest of $1·5 million ($29m x 5%) should be recorded. This is charged to the statement of profit or loss and increases the carrying amount of the liability:

Dr Finance costs	$1·5 million
Cr Liability	$1·5 million

Property, plant and equipment (PPE)

During the measurement period IFRS 3 states that adjustments should be made retrospectively if new information is determined about the value of consideration transferred, the subsidiary's identifiable net assets, or the non-controlling interest. The measurement period ends no later than 12 months after the acquisition date.

The survey detailed that Chandler's PPE was overvalued by $10 million as at the acquisition date. It was received four months after the acquisition date and so this revised valuation was received during the measurement period. As such, goodwill at acquisition should be recalculated. As at the acquisition date, the carrying amount of PPE should be reduced by $10 million and the carrying amount of goodwill increased by $10 million:

Dr Goodwill	$10 million
Cr PPE	$10 million

NCI

The NCI at acquisition was valued at $34 million but it should have been valued at $32 million (($170m – $10m PPE adjustment) x 20%). Both NCI at acquisition and goodwill at acquisition should be reduced by $2 million:

Dr NCI	$2 million
Cr Goodwill	$2 million

Goodwill

Goodwill arising on the acquisition of Chandler should have been calculated as follows:

	$m
Fair value of consideration ($150m + $29m)	179
NCI at acquisition	32
Fair value of identifiable net assets acquired	(160)
Goodwill at acquisition	51

Goodwill impairment

According to IAS 36 *Impairment of Assets*, a cash generating unit to which goodwill is allocated should be tested for impairment annually by comparing its carrying amount to its recoverable amount. As goodwill has been calculated using the proportionate method, then this must be grossed up to include the goodwill attributable to the NCI.

	$m	$m
Goodwill	51	
Notional NCI ($51m x 20/80)	12·8	
Total notional goodwill		63·8
Net assets at reporting date:		
Fair value at start of period	160	
Profit for period	52	
		212
Total carrying amount of assets		275·8
Recoverable amount		(250·0)
Impairment		25·8

The impairment is allocated against the total notional goodwill. The NCI share of the goodwill has not been recognised in the consolidated financial statements and so the NCI share of the impairment is also not recognised. The impairment charged to profit or loss is therefore $20·6 million ($25·8m x 80%) and this expense is all attributable to the equity holders of the parent company.

Dr Operating expenses	$20·6 million
Cr Goodwill	$20·6 million

The carrying amount of the goodwill relating to Chandler at the reporting date will be $30·4 million ($51m acquisition – $20·6m impairment).

(ii) Doyle

The share sale results in Hill losing control over Doyle. The goodwill, net assets and NCI of Doyle must be derecognised from the consolidated statement of financial position. The difference between the proceeds from the disposal (including the fair value of the shares retained) and these amounts will give rise to a $47 million profit on disposal. This is calculated as follows:

	$m	$m
Proceeds		140
Fair value of remaining interest		300
		440
Goodwill at disposal		(50)
Net assets at disposal		(590)
NCI:		
At acquisition	215	
NCI % of post acquisition profit (40% x ($590m – $510m))	32	
NCI at disposal		247
Profit on disposal		47

After the share sale, Hill owns 40% of Doyle's shares and has the ability to appoint two of the six members of Doyle's board of directors. IAS 28 *Investments in Associates and Joint Ventures* states that an associate is an entity over which an investor has significant influence. Significant influence is presumed when the investor has a shareholding of between 20 and 50%. Representation on the board of directors provides further evidence that significant influence exists.

Therefore, the remaining 40% shareholding in Doyle should be accounted for as an associate. It will be initially recognised at its fair value of $300 million and accounted for using the equity method. This means that the group recognises its share of the associate's profit after tax, which equates to $24·6 million ($123m x 6/12 x 40%). As at the reporting date, the associate will be carried at $324·6 million ($300m + $24·6m) in the consolidated statement of financial position.

(iii) Convertible bond

Hill has issued a compound instrument because the bond has characteristics of both a financial liability (an obligation to repay cash) and equity (an obligation to issue a fixed number of Hill's own shares). IAS 32 *Financial Instruments: Presentation* specifies that compound instruments must be split into:

– a liability component (the obligation to repay cash);
– an equity component (the obligation to issue a fixed number of shares).

The split of the liability component and the equity component at the issue date is calculated as follows:

– the liability component is the present value of the cash repayments, discounted using the market rate on non-convertible bonds;
– the equity component is the difference between the cash received and the liability component at the issue date.

The initial carrying amount of the liability should have been measured at $17·9 million, calculated as follows:

Date	Cash flow	Discount rate	Present value
	$m		$m
30 September 20X6	0·8	0·909	0·73
30 September 20X7	20·8	0·826	17·18
			17·91

The equity component should have been initially measured at $2·1 million ($20m – $17·9m).

The adjustment required is:

Dr Non-current liabilities	$2·1m
Cr Equity	$2·1m

The equity component remains unchanged. After initial recognition, the liability is measured at amortised cost, as follows:

1 October 20X5	Finance charge (10%)	Cash paid	30 September 20X6
$m	$m	$m	$m
17·9	1·8	(0·8)	18·9

The finance cost recorded for the year was $0·8 million and so must be increased by $1·0 million ($1·8m – $0·8m).

Dr Finance costs	$1·0m
Cr Non-current liabilities	$1·0m

The liability has a carrying amount of $18·9 million as at the reporting date.

(b) Deferred tax

According to IAS 12 *Income Taxes*, an entity should recognise a deferred tax asset in respect of the carry-forward of unused tax losses to the extent that it is probable that future taxable profit will be available against which the losses can be utilised. IAS 12 stresses that the existence of unused losses is strong evidence that future taxable profit may not be available. For this reason, convincing evidence is required about the existence of future taxable profits.

IAS 12 says that entities should consider whether the tax losses result from identifiable causes which are unlikely to recur. Hill has now made losses in three consecutive financial years, and therefore significant doubt exists about the likelihood of future profits being generated.

Although Hill is forecasting an improvement in its trading performance, this is a result of new products which are currently under development. It will be difficult to reliably forecast the performance of these products. More emphasis should be placed on the performance of existing products and existing customers when assessing the likelihood of future trading profits.

Finally, Hill breached a bank loan covenant and some uncertainty exists about its ability to continue as a going concern. This, again, places doubts on the likelihood of future profits and suggests that recognition of a deferred tax asset for unused tax losses would be inappropriate.

Based on the above, it would seem that Hill is incorrect to recognise a deferred tax asset in respect of its unused tax losses.

Covenant breach

Hill is currently presenting the loan as a non-current liability. IAS 1 *Presentation of Financial Statements* states that a liability should be presented as current if the entity:

– settles it as part of its operating cycle, or
– is due to settle the liability within 12 months of the reporting date, or
– does not have an unconditional right to defer settlement for at least 12 months after the reporting date.

Hill breached the loan covenants before the reporting date but only received confirmation after the reporting date that the loan was not immediately repayable. As per IAS 10 *Events after the Reporting Period*, the bank confirmation is a non-adjusting event because, as at the reporting date, Hill did not have an unconditional right to defer settlement of the loan for at least 12 months. In the statement of financial position as at 30 September 20X6 the loan should be reclassified as a current liability.

Going concern

Although positive forecasts of future performance exist, management must consider whether the breach of the loan covenant and the recent trading losses place doubt on Hill's ability to continue as a going concern. If material uncertainties exist, then disclosures should be made in accordance with IAS 1.

2 Provision

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that a provision should only be recognised if:

– there is a present obligation from a past event,
– an outflow of economic resources is probable, and
– the obligation can be measured reliably.

No provision should be recognised because Gustoso does not have an obligation to incur the training costs. The expenditure could be avoided by changing the nature of Gustoso's operations and so it has no present obligation for the future expenditure.

The provision should be derecognised. This will reduce liabilities by $2 million and increase profits by the same amount.

Contract

IFRS 9 *Financial Instruments* applies to contracts to buy or sell a non-financial item which are settled net in cash. Such contracts are usually accounted for as derivatives. However, contracts which are for an entity's 'own use' of a non-financial asset are exempt from the requirements of IFRS 9. The contract will qualify as 'own use' because Gustoso always takes delivery of the wheat. This means that it falls outside IFRS 9 and so the recognition of a derivative is incorrect.

The contract is an executory contract. Executory contracts are not initially recognised in the financial statements unless they are onerous, in which case a provision is required. This particular contract is unlikely to be onerous because wheat prices may rise again. Moreover, the finished goods which the wheat forms a part of will be sold at a profit. As such, no provision is required. The contract will therefore remain unrecognised until Gustoso takes delivery of the wheat.

The derivative liability should be derecognised, meaning that profits will increase by $0·5 million.

Ethical implications

The users of Gustoso's financial statements, such as banks and shareholders, trust accountants and rely on them to faithfully represent the effects of a company's transactions. IAS 1 *Presentation of Financial Statements* makes it clear that this will be obtained when accounting standards are correctly applied.

Both of the errors made by Gustoso overstate liabilities and understate profits. It is possible that these are unintentional errors. However, incentives exist to depart from particular IFRS and IAS standards: most notably the bonus scheme. The bonus target in 20X7 has been exceeded, and so the finance director may be attempting to shift 'excess' profits into the next year in order to increase the chance of meeting 20X8's bonus target. In this respect, the finance director has a clear self-interest threat to objectivity and may be in breach of ACCA's *Code of Ethics and Conduct*.

The accountant is correct to challenge the finance director and has an ethical responsibility to do so. Despite the fact that the finance director is acting in an intimidating manner, the accountant should explain the technical issues to the director. If the director refuses to comply with accounting standards, then it would be appropriate to discuss the matter with other directors and to seek professional advice from ACCA. Legal advice should be considered if necessary. The accountant should keep a record of conversations and actions. Resignation should be considered if the matters cannot be satisfactorily resolved.

3 (a) (i) Sale of intangible

IFRS 15 *Revenue from Contracts with Customers* defines revenue as income arising from an entity's ordinary activities. Calendar's ordinary activities do not involve selling development projects. In fact, Calendar has made no such sales since 20X0. It would seem that Calendar's business model instead involves developing products for its customers, who then take over its production, marketing and sale. Stage payments and royalties are the incomes which arise from Calendar's ordinary activities and should be treated as revenue.

Based on the above, Calendar is incorrect to recognise the gain as revenue. In fact, IAS 38 *Intangible Assets* explicitly prohibits the classification of a gain on derecognition of an intangible asset as revenue.

IAS 38 defines an intangible asset as an identifiable non-monetary asset without physical substance. Intangible assets held for sale in the ordinary course of business are outside the scope of IAS 38 and are instead accounted for in accordance with IAS 2 *Inventories*. The fact that the development project was classified as an intangible asset upon initial recognition further suggests that it was not held for sale in the ordinary course of business.

If the development was incorrectly categorised in the prior year financial statements as an intangible asset, then, as per IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, this should be corrected retrospectively. However, based on the infrequency of such sales, it seems unlikely that the development was misclassified.

(ii) Contract

IFRS 16 *Leases* says that a contract contains a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. When deciding if a contract involves the right to control an asset, the customer must assess whether they have:

– The right to substantially all of the identified asset's economic benefits;
– The right to direct the asset's use.

Calendar has the right to use a specified aircraft for three years in exchange for annual payments. Although Diary can substitute the aircraft for an alternative, the costs of doing so would be prohibitive because of the strict specifications outlined in the contract.

Calendar appears to have control over the aircraft during the three-year period because no other parties can use the aircraft during this time, and Calendar makes key decisions about the aircraft's destinations and the cargo and passengers which it transports. There are some legal and contractual restrictions which limit the aircraft's use. These protective rights define the scope of Calendar's right of use but do not prevent it from having the right to direct the use of the aircraft.

Based on the above, the contract contains a lease. IFRS 16 permits exemptions for leases of less than 12 months or leases of low value. However, this lease contract is for three years, so is not short term, and is for a high value asset so a lease liability should have been recognised at contract inception. The lease liability should equal the present value of the payments yet to be made, using the discount rate implicit in the lease. A finance cost accrues over the year, which is charged to profit or loss and added to the carrying amount of the lease liability. The year-end cash payment should be removed from profit or loss and deducted from the carrying amount of the liability.

A right-of-use asset should have been recognised at the contract inception at an amount equal to the initial value of the lease liability plus the initial costs to Calendar of negotiating the lease. The right-of-use asset should be depreciated over the lease term of three years and so one year's depreciation should be charged to profit or loss.

(b) Materiality

Calendar's financial statements should help investors, lenders and other creditors to make economic decisions about providing it with resources. An item is material if its omission or misstatement might influence the economic decisions of the users of the financial statements. Materiality is not a purely quantitative consideration; an item can be material if it triggers non-compliance with laws and regulations, or bank covenants. Calendar should consider materiality throughout the process of preparing its financial statements to ensure that relevant information is not omitted, misstated or obscured.

Property, plant and equipment (PPE)

IAS 16 *Property, Plant and Equipment* states that expenditure on PPE should be recognised as an asset and initially measured at the cost of purchase. Writing off such expenditure to profit or loss is therefore not in accordance with IAS 16.

According to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, financial statements do not comply with International Financial Reporting Standards if they contain material errors, or errors made intentionally in order to present the entity's financial performance and position in a particular way. However, assuming that the aggregate impact of writing off small PPE purchases to profit or loss is not material, then the financial statements would still comply with International Financial Reporting Standards. Moreover, this decision seems to be a practical expedient which will reduce the time and cost involved in producing financial statements, rather than a decision made to achieve a particular financial statement presentation.

If implemented, this policy must be regularly reassessed to ensure that PPE and the statement of profit or loss are not materially misstated.

Disclosure notes

IAS 1 *Presentation of Financial Statements* states that application of IFRS Standards in an entity's financial statements will result in a fair presentation. As such, the use of a checklist may help to ensure that all disclosure requirements within IFRS Standards are fulfilled. However, IAS 1 and the Exposure Draft on the Practice Statement on *Application of Materiality to Financial Statements* both specify that the disclosures required by IFRS Standards are only required if the information presented is material.

The aim of disclosure notes is to further explain items included in the primary financial statements as well as unrecognised items (such as contingent liabilities) and other events which might influence the decisions of financial statement users (such as events after the reporting period). As such, Calendar should exercise judgement about the disclosures which it prepares, taking into account the information needs of its specific stakeholders. This is because the disclosure of immaterial information clutters the financial statements and makes relevant information harder to find.

Calendar may also need to disclose information in addition to that specified in IFRS Standards if relevant to helping users understand its financial statements.

4 (a) (i) Gift cards

IFRS 15 *Revenue from Contracts with Customers* says that revenue should be recognised when or as a performance obligation is satisfied by transferring the promised good or service to the customer. When a customer buys a gift card they are pre-paying for a product. Revenue cannot be recognised because the entity has not yet transferred control over an asset and so has not satisfied a performance obligation. As such, cash received in respect of gift cards should be initially recognised as a contract liability.

IFRS 15 refers to a customer's unexercised rights as breakage. The guidance for variable consideration is followed when estimating breakage. In other words, the expected breakage is included in the transaction price if it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur once the uncertainty is subsequently resolved. This means that if the company is unable to reliably estimate the breakage amount, then revenue for the unused portion of the gift card is recognised when the likelihood of the customer exercising their remaining rights becomes remote. However, if an entity is able to reliably estimate the breakage amount, then it recognises the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer.

In relation to Kiki, it appears that the amount of breakage can be reliably determined and so this should be recognised in revenue as the gift card is redeemed. For every $1 redeemed, Kiki should recognise $1·43 ($1 x 100/70) in revenue.

(ii) Royalty

According to IFRS 15, an entity should only account for revenue from a contract with a customer when it meets the following criteria:

– The contract has been approved;
– Rights regarding goods and services can be identified;
– Payment terms can be identified;
– It is probable the seller will collect the consideration it is entitled to.

At inception of the agreement, Kiki and Colour entered an explicit contract which specified payment terms and conditions. Moreover, Colour had a strong credit rating and so payment was probable. As such, it would seem that the above criteria were met. IFRS 15 says that revenue from a usage-based royalty should be recognised as the usage occurs.

Whether a contract with a customer meets the above criteria is only reassessed if there is a significant change in facts and circumstances. In July 20X7, Colour lost major customers and sources of finance. As such, it was no longer probable that Kiki would collect the consideration it was entitled to. From July 20X7, no further revenue from the contract should be recognised.

According to IFRS 9 *Financial Instruments*, non-payment is an indicator that the outstanding receivables are credit impaired. A loss allowance should be recognised equivalent to the difference between the gross carrying amount of the receivables and the present value of the expected future cash flows receivable from Colour. Any increase or decrease in the loss allowance is charged to profit or loss.

(b) Investment properties

In accordance with IAS 40 *Investment Properties*, the buildings should be initially measured at cost.

If the cost model is applied, then the buildings will be recognised at cost less accumulated depreciation and impairment losses.

If the fair value model is applied, then the buildings will be remeasured to fair value at each reporting date. Gains and losses on remeasurement are recognised in the statement of profit or loss. No depreciation is charged.

Statement of financial position

Assuming that property prices rise, the fair value model will lead to an increase in reported assets on the statement of financial position. In contrast, investment property measured using the cost model is depreciated, which reduces its carrying amount. This means that the fair value model may make Kiki appear more asset-rich. Some stakeholders may place importance on an entity's asset base, as it can be used as security for obtaining new finance. However, reporting higher assets can sometimes be perceived negatively. For example, asset turnover ratios will deteriorate, and so Kiki may appear less efficient.

If assets increase, then equity also increases. As such, the fair value model may lead to Kiki reporting a more optimistic gearing ratio. This may reduce the perception of risk, encouraging further investment.

Statement of profit or loss

In times of rising prices, the use of the fair value model will lead to gains being reported in the statement of profit or loss. This will increase profits for the period. In contrast, the depreciation charged under the cost model will reduce profits for the period. Therefore, earnings per share, a key stock market and investor ratio, is likely to be higher if the fair value model is adopted.

However, it should be noted that fair values are volatile. In some years, fair value gains may be much larger than in other years. If property prices decline, then the fair value model will result in losses. As such, reported profits are subject to more volatility if the fair value model is adopted. This may increase stakeholders' perception of risk. In contrast, the depreciation expense recorded in accordance with the cost model will be much more predictable, meaning that investors will be better able to predict Kiki's future results.

Many entities now present alternative performance measures (APMs), such as EBITDA (earnings before interest, tax, depreciation and amortisation). Other entities present 'underlying profit' indicators, which strip out the impact of non-operating or non-recurring gains or losses (such as the remeasurement of investment properties). Although the use of APMs has been criticised, Kiki may consider them to be useful in helping investors to assess underlying business performance through the eyes of management and to eliminate the impact of certain accounting policy choices.

Statement of cash flows

Accounting policy choices have no impact on the operating, investing or financing cash flows reported in the statement of cash flows.

Disclosure

It should be noted that entities using the cost model for investment properties are required to disclose the fair value. Such disclosures enable better comparisons to be drawn between entities which account for investment property under different models.

Strategic Professional – Essentials, SBR – INT
Strategic Business Reporting – International **Specimen Exam 2 Marking Scheme**

				Marks
1	**(a)**	**(i)**	Discussion 1 mark per point to a maximum	8
			Calculation	5
				13
		(ii)	Discussion 1 mark per point to a maximum	3
			Calculation	4
				7
		(iii)	1 mark for each point to a maximum	6
	(b)		1 mark for each point to a maximum	9
				35
2	Accounting issues – 1 mark per point up to maximum			6
	Ethical issues – 1 mark per point up to maximum			7
				13
	Professional			2
				15
3	**(a)**	**(i)**	1 mark per point up to maximum	6
		(ii)	1 mark per point up to maximum	9
	(b)		1 mark per point up to maximum	10
				25
4	**(a)**	**(i)**	1 mark per point up to maximum	6
		(ii)	1 mark per point up to maximum	6
	(b)		1 mark per point up to maximum	11
			Professional	2
				25