

Revising for the September 2020 exam session

Part 2

Strategic Business Reporting (SBR)

Due to the change in timing of the ACCA exams, there are now a few extra weeks before the next exam session. With this in mind, the SBR examining team highlight a few areas of the syllabus that have caused candidates problems in recent exams and give some pointers on exam techniques, specific IFRS standards and current issues.

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Introduction

This article is the second in a series which aims to help those SBR candidates who are studying for their exams. Recent examiner reports have stated that SBR candidates often do not provide an effective consideration of whether or not control has been obtained by the acquirer in a business combination. This article therefore identifies the kinds of “control” issues that candidates should be considering when constructing their response to such exam questions. It also reflects upon how share-based payments should be accounted for when they are made as part of the purchase consideration for a subsidiary in a business combination. Finally, it uses the Covid-19 pandemic as a context within which to consider what IFRS standards might be applicable to reporting entities and why.

Business combinations

Revision of the basic principles of consolidation

When answering SBR exam questions that test control, candidates don't often focus on the inter-related principles of control despite the fact that the requirement asks them to do so. Control is not simply a matter of owning more than 50% of the voting share capital of an entity and consideration of the individual elements of control in isolation can give rise to the conclusion, incorrectly, that almost any 'involvement' with another entity creates a controlling relationship. However, it is important to note that the three criteria that define control (considered below) are inter-related and that all three must be present to conclude that the acquirer (investor) has control of the subsidiary.

IFRS 10 Consolidated Financial Statements (para 7) states that an investor controls an investee when the investor has **all** of the following:

- i. Power over the investee
- ii. Exposure, or rights, to variable returns from its involvement with the investee; and
- iii. The ability to use its power over the investee to affect the amount of the investors returns

The following table considers each of the control criteria and identifies issues that candidates need to apply to the SBR exam question scenario to identify whether (or not) control has been transferred to the acquirer:

Control criteria (IFRS 10)	Considerations to apply to the SBR exam question scenario:
Power over the investee	<ul style="list-style-type: none"> • owning a majority of the voting rights is not always necessary to have control. Instead, control requires that the investor's power/rights are sufficient for it to unilaterally direct the relevant activities that most affect the investee's returns. For example, SBR candidates should consider who makes the operating, financing and capital decisions, and who appoints key management personnel. • more analysis and judgement is required to determine whether an investor with a significant minority of voting or other rights has control. For example, power over an investee can still exist even when another entity has significant influence and SBR candidates must be prepared to consider this.
Exposure or rights to variable returns	<ul style="list-style-type: none"> • returns should be interpreted broadly, for example, to include synergy benefits as well as financial returns

	<ul style="list-style-type: none"> • returns can be negative or positive • a right to returns that is fixed is not normally consistent with control
The ability to use its power to affect returns	<ul style="list-style-type: none"> • in more complex control assessments, IFRS 10 requires identification of the activities that most affect the investee's returns and how they are directed • in simple assessments, it is sufficient to consider activities at the financial and policy level.

If, after applying these considerations to the SBR exam question scenario, the outcome of the assessment of control is still unclear, other evidence must be considered, including:

- ability to direct investee to act on investor's behalf
- key management personnel or the majority of governing body are related parties of investor
- special relationships between investee and investor

Example

Joo Co and Cat Co hold 40% each of the voting rights of Door Co. The remaining 20% are held by Hag Co. A shareholders' agreement states that the purpose of Door Co is to generate capital gains from buying and selling properties. All decisions concerning buying and selling properties, and their financing require the unanimous agreement of both Joo Co and Cat Co. Joo Co is responsible for all management activities for which it receives payment and additionally has the final decision on appointments to the board of directors.

Suggested answer

The major finance and management activities will both affect Door Co's returns. Therefore, Joo Co and Cat Co should evaluate which set of activities has the greatest effect on returns. Given the purpose of Door Co is to achieve capital gains, this may indicate capital investment activities have the most significant impact. If so, the conclusion would be that Joo Co and Cat Co have joint control because these activities are directed by joint decision-making. The deemed significant influence of Hag Co would not change this assessment of which entity has power over Door Co. If however management activities and key management personnel appointments are considered more significant, the conclusion would be that Joo Co has control of Door Co because it solely directs these relevant activities.

Guidance

Different exam question scenarios will provide different amounts of information and sometimes it won't be possible to consider all of the control criteria that has been identified in the table above. However, SBR candidates should ensure that their response considers more than just the 50% ownership criteria. In doing so, they can demonstrate that they are aware that other criteria exist and that they know how to apply them. Such an approach is likely to produce an answer that has both breadth and depth.

Share based payment – replacement awards on acquisition

Another issue that SBR candidates appear to struggle with is the accounting treatment required when an entity includes a share-based payment as part of the consideration paid for a subsidiary in a business combination; for example, when the acquirer agrees to take over any existing share-based payment awards that have already been issued to the employees of the acquiree. Alternatively, the acquirer may change the terms of the share-based payment awards to provide an incentive for key employees to remain an employee of the acquired entity. Such transactions are included within the scope of IFRS 2 Share-based Payment.

Such an arrangement needs to be analysed to determine whether it represents compensation for services in the pre-combination/acquisition period, the post-combination/acquisition period, or both. Amounts attributable to the pre-acquisition period should be accounted for as part of the purchase consideration. Amounts attributable to the post-acquisition period should be recognised as a cost of that period. Amounts attributable to both the pre- and post- acquisition periods should be allocated to the purchase consideration and post-acquisition costs accordingly.

Transactions that benefit the acquiree before the acquisition are included as part of the purchase consideration. If the transaction was arranged for the economic benefit of the acquirer, the transaction is not deemed to be part of the purchase consideration.

Example

On 1 April 20X3, Natural Co granted equity share-based payment awards to its employees. These shares awards had a fair value of \$20 million and were subject to the employees remaining in employment for the next 3 years.

On 1 April 20X5, Digital Co purchased all of the share capital of Natural Co for cash of \$80 million. A condition of the acquisition is that Digital Co is required to issue replacement equity share awards to the employees of Natural Co that will vest on 31 March 20X6.

On 1 April 20X5, the fair value of Natural Co's net assets was \$90 million, the fair value of the original share award was \$24 million and that of the replacement share awards was \$28 million.

The financial year end is 31 March each year.

Required: calculate the impact of the share-based payment awards when accounting for the acquisition, including goodwill.

Suggested answer

The amount of the replacement share award that is attributable to pre-acquisition services is determined by multiplying the fair value of the original award by the ratio of the vesting period completed at the date of the business combination to the greater of:

- The total vesting period, as determined at the date of the business combination; and
- The original vesting period

The period before the date of acquisition is (a) 2 years [1 April 20X3 to 31 March 20X5].

The vesting period of the replacement awards is (b) 1 year (b) [1 April 20X5 to 31 March 20X6].

The original vesting period is (c) 3 years [1 April 20X3 to 31 March 20X6].

Therefore, the total vesting period at 1 April 20X5 is 3 years (a+b) which is the same as the original vesting period.

The pre-acquisition service amount is \$24 million x 2 years/3 years = \$16 million – this is accounted for as part of the purchase consideration (see below).

The post-acquisition service amount therefore is (\$28-\$16) million i.e. \$ 12 million – this is accounted for as a cost for the year ended 31 March 20X6.

Goodwill at 1 April 20X5	\$m
Cash consideration	80
Equity-share based awards	16
	96
Net assets of Natural Co (fair value)	90
Goodwill	6
At 31 March 20X6 (vesting date)	\$m
Remuneration cost (PL)	12
Equity-share based awards (SFP- Equity)	12

The above approach is a sensible one which is also logical and clear to mark. Therefore, it is an approach that the SBR examining team recommends that you follow when answering similar such questions.

The accounting considerations of a pandemic or other natural disaster

Learning outcome F1(c) of the SBR syllabus states that candidates should be able to:

Discuss the impact of current issues in corporate reporting. This learning outcome may be tested by requiring the application of one or several existing standards to an accounting issue. It is also likely to require an explanation of the resulting accounting implications (for example, accounting for cryptocurrency in the Digital Age or accounting for the effects of a natural disaster and the resulting environmental liabilities).

The Covid-19 pandemic is an example of a natural disaster which has undoubtedly had an impact on the financial reporting practices of many entities in different business contexts. Indeed, many entities are experiencing conditions that are often associated with a significant economic downturn. However, there is no one particular IFRS standard that is more relevant than any other. The SBR examining team has often commented that candidates incorrectly think that only one IFRS standard can be used to provide an answer to an exam question scenario. Such an approach is likely to produce a response that is very narrow in its consideration of the issues applicable to the exam question scenario. By using the context of the Covid-19, the following table demonstrates the wide number of IFRS standards that are impacted by this pandemic which would also apply to other situations like economic downturns.

The following tables consider some of the existing accounting requirements that should be considered when addressing the financial effects of the COVID-19 outbreak:

IFRS Standards	Issues for discussion
IAS 1 Presentation of Financial Statements	Assessment of an entity's ability to continue as a going concern at the dates the financial statements are approved. Disclose uncertainties - significant judgements and sources of estimation/uncertainty need to be appropriately disclosed. This will also have impacts on the going concern assessments if judged material. If going concern is at issue consider preparation of financial statement on net realizable basis/net settlement value.
IAS 2 Inventories	Inventory must be stated at the lower of cost or net realisable value (NRV) however NRV calculation may be challenging (no market prices or no demand for products).

	<p>Entities may need to reassess their practices for fixed overhead cost allocation as production levels fall materially.</p> <p>Obsolete inventory considerations, especially perishable inventory.</p>
IAS 10 Events after the reporting period	<p>The evaluation of Covid-19 information that becomes available after the end of the reporting period but before the date of authorisation of the financial statements.</p> <p>Entities will need to judge how much of the impact of COVID-19 should be considered to arise from adjusting or non-adjusting events given the dates when knowledge of the pandemic became known and events like travel bans, lockdowns and similar took effect.</p>
IAS 12 Income Taxes	<p>Recovery of deferred tax (DT) assets arising from accumulated tax losses and therefore assess probable future taxable profits or tax planning opportunities or whether sufficient DT liabilities which are expected to reverse.</p> <p>Will entities have to restrict the Dt Asset recognised?</p> <p>Consequences of adjustments to the carrying amounts of assets and liabilities will have DT impact. Some examples will include the Impact of impairment losses or decreases in the value of a pension surplus.</p>
IAS 19 Employee Benefits	<p>Adjustments/provisions for severance.</p> <p>Falls in interest rates and plan asset portfolios may require significant adjustments requiring the services of actuaries to reflect changes in any defined benefit schemes.</p>
IAS 20 — Accounting for Government Grants and Disclosure of Government Assistance	<p>Government assistance to help entities that are experiencing financial difficulty.</p> <p>Reimbursement of employment costs is recognised in profit or loss. Disclosure of aid such as short-term debt facilities.</p>
IAS 23 Borrowing Costs	<p>Suspension of capitalisation of borrowing costs if Covid-19 has interrupted the acquisition, construction or production of a qualifying asset. Any borrowing costs incurred during such periods should be expensed through P/L.</p>
IAS 36 Impairment of Assets	<p>Assess whether the impact of COVID-19 has potentially led to an asset impairment (tangible, intangibles and financial assets) -effectively Covid-19 is a trigger event that indicates an impairment review is required.</p> <p>Management may face significant challenges in preparing the budgets and forecasts necessary to estimate the recoverable amount of an asset (or CGU) because of decreased demand, business interruptions, cancelled orders and similar issues.</p>

	Difficulty assessing fair values when no active market or market participants
IAS 37 Provisions, Contingent Liabilities and Contingent Assets	Potential restructuring provisions and onerous contract provisions may need measured and recognised and insurance recoveries disclosed (need to assess certainty of these recoveries). If material expenses or income for example restructuring and onerous contract provisions and impairment losses) should they be disclosed separately?
IFRS 2 Share-based Payment	Vesting conditions for share-based payments with performance conditions may not be met.
IFRS 5 Non-current Assets Held for Sale and Discontinued Operations	An asset (or a disposal group) no longer meets the conditions for 'held for sale' for example an entity may now face difficulties in identifying a buyer or in completing the sale within the 12-month period from classification. Ceased operations that meet the definition of discontinued operations will require separate presentation and disclosure.
IFRS 9 Financial Instruments	Allowance for expected credit losses (ECL) - reductions in forecasts in economic growth increase the probability of default and entities will need to revisit the provision matrix approach for trade receivables. Classification of financial assets - consider whether there has been a change in the entity's business model. An entity may decide or need to sell receivables classified as 'held to collect' which will therefore change classification. Hedge accounting – entities may need to consider whether the transaction is still a “highly probable forecasted transaction”. There will be many more considerations with IFRS 9 regarding interest rate changes/debt covenants/modifications to payment terms.
IFRS 13 Fair Value Measurement	Companies need to look at the decisions, assumptions and inputs to fair value measurement as market-based measures are likely to change significantly and perhaps in unpredictable ways. If using level 2 or 3 inputs will require more extensive disclosure.
IFRS 15 Revenue from contracts with customers	Contract enforceability - may not be able to approve a contract under an entity's normal business practices Collectability – may be a significant deterioration of a customer's ability to pay. Contract modifications – entity may grant a price concession to a customer. Variable considerations – an entity may need to consider updating its estimated transaction price Significant financing component -an entity may provide extended payment terms.

	Revenue recognition - an entity may need to reconsider the timing of revenue recognition if it is unable to satisfy its performance obligations on a timely basis.
IFRS 16 Leases	Impairments to right-of use assets. Economic stimulus measures have led to lower interest rates and changes to lease terms – lease liabilities may need remeasured. Impairments of lease receivables for lessors.

Other non-IFRS considerations	
Discount rates	Many central banks have cut their base rates – this will affect the measurement of many assets and liabilities
Alternative performance measures	Entities may consider providing new alternative performance measures (APMs) or adjust existing APMs – adequate/extensive disclosures will be required to ensure they do not mislead

Whilst the SBR examining team is not stating that consideration of **all** of these IFRS standards would be required, or could be expected, to answer an SBR exam question, the table does demonstrate that the accounting context of Covid-19 requires the consideration of a range of accounting standards and has wide and varied implications. Likewise, an SBR exam question is unlikely to require the consideration of only one IFRS standard in isolation. SBR candidates should use the signposts and clues contained in the question scenario to identify which IFRS standards that they should consider.

Conclusion

Given the delay that some candidates are experiencing in sitting their ACCA exams, this article should be used to stimulate thoughts about how these issues might impact on responses when practicing SBR exam questions. However, this article should not be interpreted as a signpost to the content of future SBR exam questions. ACCA candidates should also use this additional time to focus on wider reading including making use of the learning resources that ACCA have available on the SBR website such as technical articles and the Examiner Reports. By using these resources now, exam techniques can be refined and improved.