



Mock One

Corporate
Reporting
(International)

P2CR-MK1-Z17-A

Answers & Marking Scheme

Paper P2

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1 TRAVELER

(a) Consolidated statement of financial position at 30 November 2017

	\$m	
Assets		
Non-current assets		
Property, plant and equipment (W8)	1,842.28	4
Goodwill (W3)	69.2	9½
Financial assets (W4)	129.27	5
	<hr/>	
	2040.75	
Current assets (1,067 + 781 + 350)	2,198	½
	<hr/>	
Total assets	4,238.75	
Equity and liabilities		
Equity attributable to owners of parent		
Share capital	1,120	1
Retained earnings (W5)	980.55	7½
Other components of equity (W5)	91.7	3
	<hr/>	
	2,192.25	
Non-controlling interest (W6)	343.5	3
	<hr/>	
	2,535.75	
Total non-current liabilities (455 + 323 + 73)	851	½
Defined benefit liability (W7)	138	½
Current liabilities (202 + 199 + 313)	714	½
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Total liabilities	1,703	
	<hr/>	
Total equity and liabilities	4,238.75	35
	<hr/>	

WORKINGS

These marks are not to be double counted.
Method marks are awarded for own figures.

(1) Data

	\$m	\$m	
Fair value of consideration for 60% interest		600	½
Fair value of non-controlling interest		395	½
Fair value of identifiable net assets acquired:			
Share capital	600		
Retained earnings	299		
Other components of equity	26		
Fair value adjustment – land (balance)	10		
	<u> </u>	(935)	1
Goodwill		<u> </u>	
		60	

Further acquisition of 20%

	\$m	\$m
Fair value of consideration		220
Non-controlling interest at 1 December 2016	395	
Increase in net assets to 30 November 2017: $((1,079 + 10) - 935) \times 40\%$	61.6	
	<u> </u>	
Non-controlling interest 30 November 2017	456.6	
	<u> </u>	
Transfer to equity 20%/40%		228.3
		<u> </u>
Positive movement in equity		8.3
		<u> </u>

(2) Captive

	\$m	\$m	
Purchase consideration		541	½
Non-controlling interest $(526 \times 20\%)$		105.2	½
Less fair value of identifiable net assets:			
Share capital	390		
Retained earnings	90		
Other components of equity	24		
Fair value adjustment – land (balance)	22		
	<u> </u>	(526)	½
Goodwill		<u> </u>	
		120.2	

The assets transferred as part of the consideration need to be removed from non-current assets, and the gain on disposal needs to be calculated. The proceeds of \$64m credited to profit needs to be removed. The sale consideration is \$64 million and the carrying amount is \$56 million, giving a gain on disposal of \$8 million. The adjustment required to arrive at the gain is:

Dr	Retained earnings	\$56m	
Cr	Non-current assets		\$56m

(3) Impairment of goodwill

Data

	\$m	\$m	
Goodwill		60	½
Identifiable net assets			
Net assets	1,079		
Fair value adjustment – land	10		
		<hr/>	
		1,089	½
Total		1,149	
Recoverable amount		(1,099)	1
		<hr/>	
Goodwill impairment		50	
		<hr/>	

The goodwill impairment relating to Data will be split 80:20 between the group and the non-controlling interest. Thus retained earnings will be debited with \$40 million and non-controlling interest with \$10 million.

Tutorial note: *When non-controlling interest is measured at fair value, any goodwill impairment should be allocated on the basis of the allocation used for profit or loss (IAS 36). Given that the impairment review was at the year end when Traveler's shareholding was 80%, this is now the basis of profit allocation. It could be argued that a 60:40 split is also appropriate as this was how profits that arose in the year have been apportioned and the impairment is a loss that arose in the year, albeit at the year end.*

Captive

	\$m	\$m	
Goodwill		120.2	½
Gross up for unrecognised non-controlling interest ($120.2 \times \frac{20}{80}$)		30.05	1
Identifiable net assets			
Net assets	604		
Fair value adjustment – land	22		
		<hr/>	
		626	½
Carrying amount		776.25	
Recoverable amount		(700)	1
		<hr/>	
Impairment loss on grossed up amount		76.25	
		<hr/>	
Impairment loss on Traveler's share ($80\% \times 76.25$)		61	1
		<hr/>	
			9½
		<hr/>	

Impairment loss is initially allocated to goodwill. As the loss is less than the amount of goodwill there is no need to re-allocate against other assets of Captive.

Goodwill is therefore $\$(60 + 120.2 - 50 - 61)$ million, i.e. \$69.2 million.

Goodwill impairment of \$61 million is charged to retained earnings.

(4) Consolidated financial asset

Tutorial note: Under IFRS 9, debt instruments are subsequently measured at amortised cost if:

- The asset is held within a business model whose objective is to hold the assets to collect the contractual cash flows; and
- The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal.

The classification of an instrument is determined on initial recognition and reclassifications are only permitted on the change of an entity's business model and are expected to occur only infrequently.

Traveler **cannot** measure the instrument at fair value as the business model for holding the financial asset has not changed.

As the asset does not meet the derecognition criteria of IFRS 9 the treatment is that of a modification of the financial asset. 1

The modification loss is calculated by discounting the annual payments using the original effective interest rate of 6.7% as follows:

	\$m	
Carrying value	29.00	
PV of future cash flows:		
Year 1 $8m \times \frac{1}{1.067}$	7.50	
Year 2 $8m \times \frac{1}{1.067^2}$	7.03	
Year 3 $8m \times \frac{1}{1.067^3}$	6.59	
	(21.12)	
Impairment to profit or loss	7.88	2

An impairment loss of \$850,000, reflecting the lifetime credit losses associated with the asset, must also be recognised as the credit risk associated with the asset has increased significantly since initial recognition. 1

The carrying amount will be $\$(108 + 10 + 20 - 7.88 - 0.85)$, i.e. \$129.27m 1

(5) Equity 5

Retained earnings

	\$m	
Traveler – Balance at 30 November 2017	1,066	
Sale of non-current asset (W2)	(56)	1
Impairment of goodwill (W3) $\$(40 + 61)$	(101)	1
Impairment of financial instrument (W4) $\$(7.88 + 0.85)$	(8.73)	1
Defined benefit cost (W7)	(66)	1½
Depreciation for year factory (W8)	(2.72)	1
Post-acquisition reserves:		
Data $(60\% \times \$(442 - 299))$	85.8	1
Captive $(80\% \times \$(169 - 90))$	63.2	1
	980.55	7½

Other components of equity

	\$m	
Traveler – Balance at 30 November 2017	60	
Data post acquisition (60% × \$(37 – 26))	6.6	1
Captive (80% × \$(45 – 24))	16.8	1
Positive movement in equity	8.3	1
	91.7	3

Tutorial note: *The remeasurement on the defined benefit pension scheme (W7) could be included here rather than in retained earnings.*

(6) Non-controlling interest

	\$m	
Data (456.6 (W1) – 228.3 (W1))	228.3	1
Impairment of Data goodwill (W3)	(10)	1
Captive (20% × \$(604 + 22))	125.2	1
	343.5	3

(7) Defined benefit pension scheme

The entries for the pension scheme would be as follows:

	\$m	\$m	
Dr Profit or loss – service cost	45		½
Dr Profit or loss – interest on opening net liability	6		½
Dr Other comprehensive income – remeasurement	15		½
Cr Defined benefit liability ((1,274 – 1,136) – 72)		66	1½

Since IAS 19 does not specify where the remeasurements should be accumulated, it may be taken to retained earnings (as in W5) or, alternatively, included in other components of equity.

The closing net liability recognised by Traveler is \$138 million (1,274 – 1,136). ½

Tutorial note: *The benefits paid by the fund (\$49m) are accounted for by the fund, not Traveler, and so do not affect Traveler’s current year financial statements.*

(8) Property, plant and equipment

Traveler cannot treat the roof and the building as a single asset. They must be treated separately. The roof will be depreciated over five years at \$1 million per year; the remainder will be depreciated over 25 years taking into account the residual value at \$1.72 million per year $(\$45m - 2m) \div 25$ years). The total depreciation for the year is \$2.72 million.

	\$m	\$m	
Traveler	439		
Data	810		
Captive	620		
	<hr/>		
		1,869	1
Increase in value of land – Data (W1)		10	½
Increase in value of land – Captive (W2)		22	½
Less depreciation		(2.72)	1
Less disposal of asset (W2)		(56)	1
		<hr/>	<hr/>
		1,842.28	4
		<hr/>	<hr/>

(b) Allocation of costs – segment reporting

IFRS 8 *Operating Segments* does not prescribe how centrally incurred expenses and shared assets should be allocated to segments. However, the basis for allocating costs and expenses can have a significant effect on the segment results. 1

IFRS 8 does, however, require that amounts be allocated on a reasonable basis. For example:

- Head office management costs could be allocated on the basis of turnover or net assets. 1 each cost
- Pension expense may be allocated on the number of employees or salary expense of each segment. But, clearly, allocating the expense to a segment with no pensionable employees would not be reasonable.
- The costs of managing properties could be allocated on the basis of the type, value and age of the properties used by each segment. Different bases may be applied to each type of cost; they are not required to be consistent.

Interest may be allocated to a segment’s profit or loss even though the related interest-bearing asset or liability has not been allocated to the segment’s assets or liabilities. Such asymmetrical allocation also arises when depreciable expense and the related depreciable assets are not allocated to the same segment. max 2

Segment information presented must be measured on the same basis on which it is reported internally, even if that does not comply with IFRS or the accounting policies used in the consolidated financial statements. Examples of such situations include segment information reported on a cash basis (as opposed to an accruals basis) and reporting on a local GAAP basis for segments that are comprised of foreign subsidiaries. max 2

Although the basis of measurement is flexible, an explanation of the following must be provided:

- the basis of accounting for transactions between reportable segments;
- the nature of any differences between the segments' reported amounts and the consolidated totals.

1

For example, those resulting from differences in accounting policies and policies for the allocation of centrally incurred costs that are necessary for an understanding of the reported segment information. In addition, IFRS 8 requires reconciliations between the segments' reported amounts and the consolidated financial statements.

1

max 8

(c) Corporate social responsibility disclosures

1 mark per relevant point to a max of 7

Integrated and sustainability reporting are both considered to add value to a company; being socially responsible and complying with a corporate code should enhance the company from an outsider's perspective. Although many shareholders may hold a short-term view that focuses on current profitability, a long-term view recognises that compliance with reporting requirements should lead to greater returns in future. Although compliance will have a cost to it, it is likely that the benefits will outweigh the costs over time.

Traditional ethical conduct relating to disclosure is insufficient when applied to corporate social responsibility (CSR) disclosure because the role of company is linked with the role of a corporate citizen, which is held to a higher ethical standard.

Corporate citizens act on a social interest, which may or may not affect revenues. These socially beneficial actions raise the ethical standard for such companies because of altruistic intentions, which is entirely different from the profit-generating purpose of a company; the company needs to consider all stakeholders not just shareholders.

The ethical expectations of corporate citizens are thus more demanding than those for businesses without a social interest, especially in the way corporate citizens communicate their practices. A company that acts without thought for the greater environment may be targeted by pressure groups to reconsider its practices.

The ethics of corporate social responsibility disclosure are difficult to reconcile with shareholders' expectations. Companies must remain profitable but there may be conflict; the pursuit of short-term profits may not increase shareholder wealth in the longer term. For example, a company would make more profit by dumping toxic by-products rather than dispose of them responsibly. This may not only result in future costs (e.g. fines, litigation and clean-up costs), but lose the support of other providers of finance, customers and suppliers. Paying a relatively small amount today to dispose of toxic waste in a responsible manner is in the interest of the company's long-term survival and should increase returns to shareholders.

Maintaining integrity becomes more challenging when a company may report less profit and thus lower directors' bonuses. The problem that faces many companies is how to ethically, legally, and effectively disclose information while maintaining their market position.

It can be argued that increased CSR disclosure is in itself a form of socially responsible behaviour, and that by offering more information to the public, companies better meet their responsibilities to stakeholders. There are ethical implications of companies using CSR reporting for the sole purpose of improving revenue.

The ethical implications are exacerbated if the desired effects of disclosing responsible conduct are solely to improve profitability. Disclosing good conduct solely for profit is unacceptable because it exploits something of much higher value (right conduct) to promote something which may be thought as being of lower value (profit).

2 SELTEC

(a) Financial Instruments

IFRS 9 *Financial Instruments* defines a derivative as a financial instrument:

1 for definition
1 for examples

- Whose value changes in response to the change in an underlying variable such as an interest rate, commodity or security price, or index (e.g. the price of edible oil);
- That requires no initial investment, or one that is smaller than would be required for a contract with similar response to changes in market factors (e.g. for the future purchase of oil, the initial investment in a forward contract for the oil would be minimal); and
- That is settled at a future date.

However, when a contract's purpose is to take physical delivery of a non-financial asset, such as the oil, in the normal course of business, the contract is not usually considered to be a financial instrument under IFRS 9. A contract of this nature can be designated at fair value through profit or loss to eliminate an "accounting mismatch". The designation is only allowed at the start of a contract.

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Even though Seltec often takes physical delivery of oil, to sell it shortly afterwards, it also has a practice of settling similar contracts on a net basis, using the proceeds to buy a different type of oil or from a different provider. As the contracts are designed for future delivery, hedge accounting will only be allowable if Seltec designates the contract at fair value through profit or loss at inception.

1

The following criteria must all be met:

max 3

- The relationship consists only of eligible hedging instrument and hedged items;
- At inception, there is a formal designation of the relationship and of the entity's risk management objective; and
- The relationship meets all the hedge effectiveness requirements:
 - there is an economic relationship between the hedged item and hedging instrument;
 - the effect of credit risk does not dominate the value changes that result from the economic relationship; and
 - the hedge ratio of the relationship is the same as the hedge ratio of the actual quantity of the hedging instrument used to the actual quantity of the hedged item.

If these criteria are met, Seltec could apply hedge accounting to the transaction to purchase oil using a fair value hedge of a cash flow hedge: max 1

- For a fair value hedge, the forward or future contract (a derivative) is designated the hedging instrument and the value of the oil designated as the hedged item;
- For a cash flow hedge, the hedging instrument would also be the derivative and the cash flow associated with the oil would be the hedged item.

The aim of hedge accounting is to minimise the volatility in profit or loss by recognising the gain or loss on the hedge item in profit and loss in the same period as the gain or loss on the hedging instrument. A fair value hedge will bring forward the movement on the hedged item earlier than if hedge accounting had not been used; whereas a cash flow hedge will defer the change in value of the hedging instrument to the period when the cash flows of the hedged item impact on profit or loss. Hedge accounting would therefore help Seltec to manage any earnings volatility that is generated through the oil contracts. max 2

IFRS 9 is restrictive because of the difficulty of isolating and measuring the cash flows attributable to the specific risks of non-financial items. Assuming all the documentation criteria are met, Seltec can use hedge accounting but may favour a fair value hedge in order to reduce earnings volatility. 1

The unrecognised contractual commitment that Seltec has to buy the edible oil will be designated as the hedged item with the derivative designated as the hedging instrument. The change in fair value of the edible oil will be recognised as an asset or liability with the double entry to profit or loss. At the same time, the change in fair value of the future or forward contract will be recognised in profit or loss with a corresponding asset or liability recognised in the statement of financial position. 1

If Seltec does not use hedge accounting, the change in fair value of derivative will still be recognised in profit or loss but there would be no recognition of the hedged item; this would cause volatility in profits from period to period. 1

The contract to buy oil from a foreign company denominated in pounds sterling, which is neither the functional currency of the buyer or seller, contains an embedded derivative; for Seltec this will be the movement in the dollar against the pound sterling. 1

Under IFRS 9, an embedded derivative is a component of a hybrid instrument that also includes a non-derivative host contract; some of the cash flows of the instrument vary in a way similar to a stand-alone derivative. As derivatives must be accounted for at fair value in the statement of financial position with changes recognised through profit or loss, so must some embedded derivatives. 1

If the host contract is a financial asset, there is no need to separate the two components and the embedded derivative will be accounted for as a single contract. If the host contract falls outside of the scope of IFRS 9, the embedded derivative will be separated and accounted for as a derivative if: 1

- the economic risks and characteristics of the embedded derivative are not closely related to those of the host contract; max 1
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- the entire instrument is not measured at fair value with changes in fair value recognised in profit or loss.

In this case the pound sterling is not the functional currency of either party, and oil does not appear to be denominated in sterling as most of Seltec’s other contracts are denominated in dollars. Additionally, the economic risks are not closely related as currency fluctuations and changes in the price of oil have different risks. 1

The host contract is not measured at fair value but the currency element would meet the definition of a derivative if it were a separate instrument with the same terms. The currency derivative should therefore be accounted for at fair value through profit or loss. 1

In conclusion:

- The arrangement contains an embedded derivative; 1 for summary
- The embedded derivative is not closely related to the host contract;
- The embedded derivative must be separated from the host contract; and —
- The derivative is measured at fair value through profit or loss. max14 —

(b) Intangible assets and purchase of entities

Brands are intangible assets and will be capitalised at cost if separately acquired. Once recognised under the cost model, a brand will be amortised unless it has an indefinite life. A brand cannot be revalued; a unique asset does not have an active market. 1

Intangible assets are classified as having:

- An indefinite life: No foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity; or 1
- A finite life: A limited period of benefit to the entity.

Factors that should be considered in determining useful life are: 1

- The entity’s commitment to support the brand;
- The extent to which the brand has long-term potential that is not underpinned by short-term fashion or trends (i.e. proven success);
- The extent to which the products carrying the brand are resistant to changes in the operating environment (i.e. changes in the legal, technological and competitive environments).

The brand of oil, which has been in existence for many years and has proven success, may be regarded as having an indefinite life if Seltec plans to manage this brand efficiently and does not foresee any limitations. It should not be amortised but tested annually for impairment (or whenever there is an indication of impairment). Its useful life will also be reviewed annually to determine if circumstances still support an indefinite useful life; if not it will be amortised over its finite life. A change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate. max 3

The oil named after a film star is likely to decline in popularity if the popularity of the film star declines. As a new product it is likely to have a finite life. The film star’s reputation may affect its longevity (e.g. the award of an Oscar could extend the life of the brand). 1

The cost less residual value of an intangible asset with a finite useful life should be amortised on a systematic basis over that life. The amortisation method should reflect the pattern in which the brand's benefits are expected to be consumed; if the pattern cannot be determined reliably, the straight-line method must be used. 1

A business combination is a transaction or event in which an acquirer obtains control of one or more businesses. 1

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return directly to investors or other owners, members or participants in the form of dividends, lower costs or other economic benefits to investors or owners. The IASB is currently looking at what constitutes a business combination and has issued an exposure draft on the subject. 1

The two entities do not meet the definition of a business in IFRS 3 *Business Combinations* as they do not have any processes such as real estate management which are applied to the retail space that they own. The entities do not generate any outputs (e.g. rental income). Therefore the acquisition should be treated as a purchase of assets in accordance with IAS 16 *Property, Plant and Equipment*. The retail outlets will be capitalised and depreciated over their useful lives. If Seltec were to lease the retail units under operating leases, they would be accounted for as investment property (IAS 40). 1

max 9

2 marks are available for the professional content of the answer.
Judgement should be applied when allocating these 2 marks

3 COHORT

Deferred tax implications

Max of 2 marks for opening statements

The acquisition of the subsidiaries during the year affects the deferred taxation charge. The deferred tax position is reviewed as that of the enlarged group as a whole. An individual company may not be able to recognise, for example, a deferred tax asset but it may now be able to because there are tax profits of the acquiree available to utilise any unused tax losses.

Therefore provision is made for all differences between the fair values recognised for the net assets (Air \$4 million) and their tax bases (Air \$3.5 million). No provision is required in respect of the temporary difference arising on the recognition of non-tax deductible goodwill.

Cohort is planning to list its shares on a recognised stock exchange without issuing new shares. The company will become a publicly traded company and, given the directors' belief in the growth of the company, it would appear that it will be subject to the standard rate of taxation for public companies in the future.

Deferred taxation should be measured at the tax rates expected to apply when the asset is realised or the liability is settled, based on current enacted tax rates and laws. If some of the temporary differences reverse at the higher tax rate, deferred tax should therefore be provided at this rate on those items.

(a) Acquisition of Air

1 mark each relevant comment to max of 10

(i) As stated above, the tax base of Air's net assets remains unchanged at \$3.5 million; the directors were wrong to increase the tax base to reflect the difference between the fair value and carrying amount. The increase to fair value of \$200,000 creates a taxable temporary difference on acquisition of the same amount. This taxable temporary difference gives rise to a deferred tax liability of \$60,000 on the acquisition of Air, which should be recognised in the consolidated financial statements only; not in the statements of Air (unless Air were to revalue the land in its separate financial statements).

(ii) The intra-group profit in inventory is eliminated on consolidation (\$0.6 million) but no equivalent adjustment is made for tax purposes.

Taxes paid by the seller on these profits have been included in the consolidated statement of comprehensive income for the period.

The deductible temporary difference of \$600,000 between the carrying amount of inventory (\$1.2 million) and its higher tax base (\$1.8 million) is provided for at the receiving company's rate of tax (Cohort) of 30% since it will be Cohort that ultimately realises the cash flow from the sale of the inventory. The temporary difference arises in its statements. This will give rise to a deferred tax asset of \$180,000, provided that Cohort has deferred tax liabilities, or future taxable profits, against which the deferred tax asset can be offset.

(iii) Provision is required on the unremitted profits of subsidiaries if the parent is unable to control the timing of the remittance or it is probable that remittance will take place in the foreseeable future.

Cohort seems to be recovering the carrying amount of its investment in Air. Dividend payments are under the control of Cohort and it would not normally recognise the deferred tax liability in respect of the undistributed profits of Air.

However, as the profits are to be distributed and tax would be payable on the amount remitted, a provision for deferred tax should be made. The deferred tax liability of \$600,000 is calculated as the cumulative dividend, expected to be \$2 million, at Cohort's tax rate of 30%, as Cohort will be receiving the dividend. As retained earnings are expected to be realised over a four-year period the deferred tax liability will reduce each year to reflect the remaining retained earnings.

(b) Acquisition of Legion

1 mark each relevant comment to max of 11

- (i) When a portfolio of investments is remeasured to an amount in excess of the previous carrying amount, a temporary difference will arise if the tax treatment of the fair value gain differs from the accounting treatment.

The fair value gain has been included in profit or loss. If the tax base was adjusted for the surplus, no temporary difference would arise. However, in this case, the tax base is not adjusted as the increase in the carrying amount will affect taxable income in future periods.

Therefore the difference between the carrying amount of the investments and its tax base will be a temporary difference (\$4 million) and give rise to a deferred tax liability.

The resulting deferred tax expense will be charged against profit or loss, not other comprehensive income, because the surplus has been recognised in profit or loss.

- (ii) When the allowance for the loss on the loan is first made a deductible temporary difference arises amounting to the difference between the carrying amount and the tax base (nil) of the provision for the loss on the loan.

Because the allowance is expected to increase, it is unlikely that the temporary difference will reverse in the short to medium term. However, this does not affect the fact that a provision for deferred tax should be made.

If the allowance for the loss affected neither accounting profit nor taxable profit, no provision for deferred tax would be required. However, the recording of the loan loss affects accounting profit now and taxable profit later.

A deferred tax asset will arise (\$2 million at tax rate), and this is subject to the general test in IAS 12 that it is probable that taxable profits will be available against which the temporary difference can be utilised.

- (iii) Unrelieved tax losses can create a deferred tax asset. Deferred tax assets should be recognised to the extent that they can be regarded as recoverable.

Recoverability is based on all the evidence available and is to the extent that it is probable that the deferred tax asset will be realised. If it is probable that either all or only part of the deferred tax asset will be realised, a deferred tax asset should be recognised for that amount.

Future realisation of deferred tax assets essentially depends on the existence of sufficient taxable profit of the appropriate type (operating profit or taxable gain). Normally suitable taxable profits will only be generated in the same taxable company and assessed by the same taxation authority as the income, giving rise to the deferred tax asset.

When Cohort acquired Legion, it expected that Legion would make sufficient taxable profits in the future to relieve the unused tax losses. A deferred tax asset was therefore recognised with a corresponding reduction in the amount of goodwill recognised on acquisition.

The deferred tax asset will be reduced to the amount that is considered probable to be realised. The deferred tax asset will be adjusted to reflect current expectations of recoverability, with a corresponding adjustment to goodwill due to the initial reduction in the amount of goodwill recognised.

2 professional marks are available.

4 MISSON

(a) IAS 21 accounting issues

IAS 21 is relevant to all companies that trade in products and services denominated in a different currency and to companies that own foreign subsidiaries, or are owned by a foreign parent. The standard is quite dated (issued 1993) and some users feel that it needs updating to keep pace with the current economic environment. Intro 1

Volatility in exchange rates can cause major fluctuations in reported profits and this volatility is likely to continue into the foreseeable future. For example:

- The financial crisis in Greece, due to the inability of the Greek government to pay its debts, significantly affected the standing of Greece in the EU. This devalued the Euro and ultimately affected companies' reported profits. 1 per example (max 2)
- The UK's decision to leave the EU ("Brexit") caused the pound sterling to fall by 15% against the US dollar overnight. This had a major impact on importers (disadvantageous) and exporters (advantageous). For example, a UK exporter would expect to see its goods and services become more popular, and therefore increase revenue, as it would cost foreign customers less to make purchases invoiced in pounds.
- The Venezuelan economy is going through a period of hyperinflation and companies whose functional currency is the Bolivar must apply IAS 29 *Financial Reporting in Hyper-inflationary Economies* as well as IAS 21. An area of major concern is that multiple exchange rates operate within the economy which has stringent exchange controls.

There is potential for conceptual confusion between the disclosure requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IFRS 7 *Financial Instruments: Disclosures*. IFRS 7 requires disclosure of market risks, including any currency risk; whereas IAS 21 makes little mention of foreign currency risk. The two standards have different conceptual bases; IFRS 7 makes a financial/non-financial distinction whereas IAS 21 makes a monetary/non-monetary distinction. Therefore the foreign currency risk in monetary items which are not financial instruments (e.g. executory contracts) may not be disclosed (because they are outside the scope of IFRS 7 and translated at the closing rate under IAS 27). max 1 (risks)

Inventory measured at the lower of cost and net realisable value is a non-monetary asset, which is not remeasured at the reporting date. However, inventories held by a commodity trader, that are denominated in a foreign currency (e.g. a UK company trading in oil which is denominated in US\$), are monetary items and therefore translated at a closing exchange rate (IAS 21). max 1 (commodities)

Tutorial note: *Inventories of commodity broker-traders measured at fair value less costs to sell are outside the scope of IAS 2.*

IAS 21 requires exchange differences relating to monetary items (except for those that are part of a net investment in a foreign operation) to be reported in profit or loss for the period. As this gain (or loss) has not yet been realised, there is an argument for recognising it in other comprehensive income, until final settlement of the outstanding amount. Unless IAS 21 is revised or the IASB gives more guidance on the use of other comprehensive income, this unrealised gain/loss will continue to be recognised in profit or loss. max 2 (monetary/non-monetary)

Some would argue that exchange differences in respect of all non-monetary items should also be reported in other comprehensive income (currently only those in respect of revalued property, plant and equipment are reported there), as a current exchange rate is being used for an item that will not be settled until many years into the future.

Variability in profit or loss would be greatly reduced if exchange differences, especially those relating to non-monetary items, were recognised in other comprehensive income rather than profit or loss. However, this would then lead to a debate on whether these exchange difference should eventually be reclassified.

IAS 21 requires transactions affecting profit or loss to be translated using the actual exchange rate at the time of the transaction. Although it allows average rates to be used (if reasonable approximations to actual), it does not define an “average” exchange rate. This leads to a lack of comparability between the financial statements of similar entities, if they have used different rates for similar transactions. max 1
(average rate)

The requirements of IAS 21 may also be in conflict with local legislation. As previously mentioned, under IAS 21, exchange differences are recognised in profit or loss and therefore deemed to be realised. If legislation regards these exchange differences as unrealised, any gains cannot be included in the determination of distributable profits for dividend payments. This can lead to confusion amongst stakeholders, who may question what is the “correct” profit. max 1
(local requirements)

Reasons why regulators may not include projects in their work plan may include:

- Conflict of a project with other work currently in process; the IASB is currently working on *Conceptual Framework* issues and does not want to take on board certain other projects until this project has been completed. 1 each reason
- The issues surrounding a project may only affect a small number of users. It may therefore be more prudent to pass the project over to IFRS IC for consideration and issue of an IFRIC, if required. ____
max 10

(b) Transactions

(i) Foreign subsidiary, Chong

The following computation sets out the accounting treatment of the sale of the foreign subsidiary, Chong:

	31 October 2016		31 October 2017		
	€m		€m		
Share capital	100		100		
Retained earnings	40		60		
	<hr/>		<hr/>		
Shareholders' equity	140		160		
	<hr/>		<hr/>		
Net assets	140		160		½
	<hr/>		<hr/>		
Translated into dollars:	\$m		\$m		
Net assets (140 ÷ 1.4)	100	(160 ÷ 1.3)	123		½
	<hr/>		<hr/>		
Share capital (100 ÷ 1.1)	91		91		½
Retained profits (40 ÷ 1.2)	33	33			½
		(20 ÷ 1.5) 13	46		½
		<hr/>			
Exchange reserve	(24)	(24)			½
		gain 10	(14)		1
	<hr/>	<hr/>	<hr/>		
	100		123		
	<hr/>		<hr/>		

As at 31 October, the net assets of Chong translated at the closing exchange rate amount to \$100 million. Share capital is \$91 million (as translated at the exchange rate ruling on acquisition) and profit for the year translated at an average exchange rate is \$33 million. Since equity must equal net assets there is an exchange loss of \$24 million (100 – (91 + 33)) which will be recognised in other comprehensive income and included as a separate component of equity. 1

As at 31 October 2017, closing net assets are \$123 million. Share capital is still \$91 million and profit for the year is calculated at \$13 million to give cumulative retained earnings of \$46 million. The cumulative exchange loss is \$14 million (123 – (91 + 46)); this leads to an exchange gain for the current year of \$10 million to be recognised in other comprehensive income. 1

<i>Gain/loss on sale</i>	<i>Misson</i>	<i>Group</i>	
	\$m	\$m	
Sale proceeds (195 ÷ 1.3)	150	150	½
Cost of investment	(91)		½
Net asset value		(123)	½
Exchange losses (24 – 10)		(14)	½
	<hr/>	<hr/>	
Gain on sale	59	13	—
	<hr/>	<hr/>	

Chong's results for the period to the date of sale will be included in the consolidated statement of profit or loss and other comprehensive income, in this case the entire year. As Chong was sold on the last day of the year, there will be no net assets to include in the consolidated statement of financial position. 1

The gain of \$13 million will be included in the consolidated profit or loss for the period and the cumulative exchange difference of \$14 million will be reclassified from other comprehensive income to profit or loss. 1
Max 8

Tutorial note: *The gain on sale is effectively the gain on sale in the parent's financial statements (\$59 million) less the cumulative profits already taken to the consolidated profit or loss of \$46 million.*

(ii) *Inventory, goods sold and investment property*

The inventory and trade payable initially would be recorded at \$5 million ($\text{€}8\text{m} \div 1.6$). At the year end, the amount payable is still outstanding and is retranslated to \$6.2 million ($\text{€}8\text{m} \div 1.3$). An exchange loss of \$1.2 million ($\text{\$}6.2\text{m} - \text{\$}5\text{m}$) would be reported in profit or loss. The inventory would be recorded at \$5 million at the year end (unless its value is impaired). ½
½
½

The sale of goods would be recorded at \$2.5 million ($\text{€}4\text{m} \div 1.6$) as a sale and as a trade receivable. Payment is received on 31 October 2018 in euros and the actual value of euros received will be \$3.1 million ($\text{€}4\text{m} \div 1.3$). ½
½

Thus a gain on exchange of \$0.6 million will be reported in profit or loss. ½

The investment property should be recognised on 1 November 2016 at \$20 million ($\text{€}28\text{m} \div 1.4$). At 31 October 2017, the property should be recognised at \$18.5 million ($\text{€}24\text{m} \div 1.3$). Although the fair value of the property has increased in Euros, a net overall loss will be recognised in profit or loss on investment property due to the fall in exchange rate. ½
½
½

The property is a non-monetary asset and any foreign currency element is not recognised separately. When a gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss is also recognised in profit or loss. If any gain or loss is recognised in equity on a non-monetary asset, any exchange gain is also recognised in equity. The components that make up the gain and or loss must be disclosed in notes to the financial statements. 1
max 5

2 marks are available for the professionalism of the discussion in part (a).
Judgement should be applied when awarding these marks

MOCK EXAM FEEDBACK SUMMARY – P2 MOCK 1

Q	Part	Topic	Study Text ref	RQB coverage	Commentary
1	(a)	Consolidated statement of financial position	18 & 20	Q37 Grange	<ul style="list-style-type: none"> ■ Read the question very carefully, there is a lot of information and it is very easy to miss something. ■ There is no one correct way of performing calculations to get the answer; but whichever way you use ensure workings are logical and x-referenced to the solution. ■ The increase in shareholding has no effect on goodwill as this is only ever calculated once control has been achieved. An increase in shareholding will lead to a movement in equity based on the cost of shares acquired compared to the value of NCI given up. ■ Ensure that you are competent in calculating goodwill under the two methods allowed by IFRS 3; they can both be examined. ■ Partial goodwill must be grossed up when carrying out impairment tests to reflect the unrecognised share. As we recognise 100% of every identifiable asset in the test, we must do the same with goodwill; this will then be comparable with the calculation of the recoverable amount of the CGU as a whole. ■ Goodwill itself is not tested for impairment; it is the CGU, where goodwill sits, that is being tested. ■ The cash flows relating to the financial asset were modified, resulting in an expense to profit or loss. Also, the asset needed to be tested for impairment loss, this figure being given in the question. Both the modification loss and the impairment loss are to be expensed. ■ Accounting for the defined benefit scheme was required, but there were no complex calculations; simply a matter of putting the given figures in the correct place. ■ Basic knowledge of F7 was required to deal with the component asset; remember that anything from F7 could be tested in P2. These should be easy marks!

MOCK EXAM FEEDBACK SUMMARY – P2 MOCK 1

Q	Part	Topic	Study Text ref	RQB coverage	Commentary
1	(b)	Operating segments	10	Q17 Norman	<ul style="list-style-type: none"> ■ Do not ignore the written elements of Q1, they are quite often the difference between a student passing or failing the exam. ■ You were not required to write everything you know about IFRS 8 – be specific and answer the question set. ■ The question requires you to apply knowledge rather than just regurgitate learned facts. ■ Focus your answer on the allocation of the three items highlighted in the question, applying simple common sense should enable you to earn three marks; you only need one more mark to earn a pass for this part.
1	(c)	Corporate social responsibility	27	Q40 Jones & Cousin	<ul style="list-style-type: none"> ■ Again, ensure that you answer this part of the question; if you do not answer it you cannot earn any marks. If you earn one mark attempting this part that might be the one mark that takes you from 49% fail to 50% pass. ■ There is no one correct answer to this question; as long as you use sensible arguments in your answer you will earn marks. ■ One of the themes of the question was the conflict between increasing shareholder wealth and being a good corporate citizen. ■ The question does not require the learning of facts but rather the ability to discuss the place of corporate reporting within the environment. You must read around the subject and not solely be reliant on your study text.

MOCK EXAM FEEDBACK SUMMARY – P2 MOCK 1

Q	Part	Topic	Study Text ref	RQB coverage	Commentary
2	(a)	Financial instruments	8	Q12 Aron	<ul style="list-style-type: none"> ■ This is quite a complex scenario – very few students will have encountered this issue in their work environment. ■ Break the question down into manageable pieces and try to isolate the basic issue and then apply your accounting knowledge to that issue. ■ Give the best definition that you can of a derivative instrument as that is the main feature of this question, you do not need to quote the IASB’s definition verbatim – then give the accounting treatment for derivatives. ■ Discuss whether hedge accounting would be allowed in this situation; it is likely based on the information given that hedge accounting would be permissible in respect to the edible oil forward and future contracts. ■ There is a second issue relating to an embedded derivative; you should have tried to define an embedded derivative. ■ In this situation, it is likely that the derivative will need to be separated from the host contract, with the derivative element measured at fair value.

MOCK EXAM FEEDBACK SUMMARY – P2 MOCK 1

Q	Part	Topic	Study Text ref	RQB coverage	Commentary
2	(b)	Intangible assets	6	Q9 Scramble	<ul style="list-style-type: none"> ■ Another scenario that most students will not have encountered in their working life; the examiner frequently takes real life situations and incorporates that scenario into an exam question. You must ensure that you read around the subject; do not rely solely on any text for this paper but look at what is happening in the world today (e.g. in the financial press, <i>student accountant</i> articles and IFRS-related websites). ■ The focus of this question is around the purchase of intangibles; it is not about the creation of internally-developed intangibles so you should not have digressed into this subject. ■ It is likely that the brand that has been around for many years could be treated as an intangible asset with an indefinite useful life, but the new brand is likely to have a finite life. Discuss the factors that would lead to the particular accounting treatment. ■ Once the treatment has been decided discuss the ongoing treatment for the two intangibles; one would be amortised and the other tested annually for impairment. It is possible that the treatment for both could switch in the future (e.g. if the new brand gets established then it may be considered to have an indefinite life). ■ The second scenario deals with the purchase of two businesses. A key point here is that the entities do not meet the definition of a business and therefore IFRS 3 is not relevant. They are to be treated as the purchase of a separate asset and accounted for in accordance with IAS 16. ■ Discussion around what constitutes a business combination would be required to earn the higher marks. Again, breaking the scenario down into its basics will allow you the chance to earn one or two marks. ■ The examiner’s reports frequently mention the need to apply knowledge to scenarios; that is what is what is required by this question – application of knowledge. Do not simply regurgitate facts learned from a study text.

MOCK EXAM FEEDBACK SUMMARY – P2 MOCK 1

Q	Part	Topic	Study Text ref	RQB coverage	Commentary
3		Deferred Tax – IAS 12	12	Q20 Panel	<ul style="list-style-type: none"> ■ Deferred tax should be considered from the group’s perspective; items that were not recognised in the single entity’s accounts may be recognised in the group accounts. ■ Any fair value differences on acquisition will give rise to deferred tax implications. ■ Take care on which tax rate to use; it is something that can easily be missed. ■ There is a degree of subjectivity in (a)(i); remember that you can suggest that the treatment may be this or it may be that! ■ Unrealised profit in inventory will give rise to a deductible temporary difference. ■ As profits seem to be distributed by the subsidiary this will cause the recognition of deferred tax on the profits of the subsidiary. ■ Fair value differences will give rise to a temporary difference if the tax base does not move; if fair values of assets increase this will lead to a taxable temporary difference. ■ Discuss the recognition criteria for deferred tax assets in respect of the loss allowance; this also leads into (b)(iii).

MOCK EXAM FEEDBACK SUMMARY – P2 MOCK 1

Q	Part	Topic	Study Text ref	RQB coverage	Commentary
4		IAS 21	22	Q31 Aspire	<ul style="list-style-type: none"> ■ This is where wider reading is required to help in answering questions of this nature. ■ Be aware of issues happening in the world and, if relevant, bring in issues that may be affecting companies you know. It is unlikely that any text book will give a full and complete answer to questions of this nature. ■ Think about the standard and then consider possible problems. One that is mentioned in texts is the lack of definition for an average exchange rate; build on that as an issue. ■ Think basic economics – exchange rates fluctuate daily; will this cause problems for companies? ■ General issue of where to show gains and losses (in profit or loss or other comprehensive income) also need to be considered; this issue is under consideration by the IASB and so could be incorporated into a solution. ■ The question also asks why projects may not be taken forward by regulators, make sure you read the requirements fully and answer all parts of the question. ■ Part (b) is the application of knowledge in two IAS 21 situations; these issues appear on a regular basis in the exam and therefore the accounting entries should not too many problems if you have studied thoroughly. ■ The question requires a discussion of the treatment, including just numbers as your solution will not earn a pass; you must ensure that you discuss the treatment, as well as showing the calculations. ■ Ensure you get the exchange rates the right way round! Do not divide when you should multiply and vice versa.