Mock Two

Corporate Reporting (International)

P2CR-MK2-Z17-A

Answers & Marking Scheme

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Paper P2

1 BRAVADO

(a) Consolidated Statement of Financial Position at 31 March 2018

		$m	
Assets:			
Non-current assets:			
*Property, plant and equipment (W9)		708	3
Goodwill (W2)		25	5
Investment in associate (W3)		22·5	2
*Other investments (W10)		44·6	2
		800·1	
Current assets:			
*Inventories (135 + 55 + 73 – 18 (W8))		245	2
*Trade receivables (91 + 45 + 32)		168	
Loans to directors		1	1
*Cash and cash equivalents (102 + 100 + 8 – 1)		209	
		623	
Total assets		1,423·1	
Equity and liabilities			
Equity attributable to owners of parent			
Share capital		520	
Retained earnings (W5)		253.8	10
Other components of equity (W5)		11	1½
		784·8	
Non-controlling interest (W7)		148·9	3
		933·7	
Non-current liabilities			
*Long-term borrowings (120 + 15 + 5)	140		
*Deferred tax (W11)	39·4		2
Total non-current liabilities		179·4	
Current liabilities			
*Trade and other payables (W6)	218		½
*Current tax payable (60 + 8 + 24)	92		
Total current liabilities		310	
Total equity and liabilities		1,423·1	

For summation of * items max 3

35

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WORKINGS

(1) Message

The following marks are not to be double counted

	$m	
Fair value of consideration for 80% interest	300	½
Fair value of non-controlling interest	86	½
	386	
Amount of identifiable net assets acquired	(400)	½
Gain on bargain purchase	(14) ⇒ W5	1½

Tutorial note: *Any gain on a bargain purchase is attributable wholly to the acquirer (IFRS 3).*

(2) Mixted

	$m	
1 April 2017 (128 – 10)	118	½
Contingent consideration	12	1
Total consideration transferred	130	
Fair value of equity interest held before business combination	15	1
Fair value of consideration	145	
Fair value of non-controlling interest	53	½
	198	
Identifiable net assets	(170)	½
Increase in value	(6)	½
Deferred tax (176 – 166) × 30%	3	1
Goodwill	25	5

(3) Clarity

The gain of $1m recognised in other components of equity may now be transferred to retained earnings, as the investment has now been realised.

Dr	Other components of equity (9 – 8)	1	
Cr	Retained earnings		1

The amount included in the consolidated statement of financial position would be:

Cost (9 + 11)	20	1
Share of post-acquisition profits (10m × 25%)	2·5	1
	22·5	2

(4) Fair value through profit or loss foreign investment

Date	*Exchange rate*	*Value*		*Change in fair value*	
	$ per Dinar	Dinars m	$m	$m	
1 April 2016	4·5	11	49·5		
31 March 2017	5·1	10	51	1·5	1
31 March 2018	4·8	7	33·6	(17·4)	1
					2

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Tutorial note: *The asset's fair value in the overseas currency has declined for successive periods. However, as the exchange rate increased in 2017, a fair value gain of $1.5m arises. So, in the year to 31 March 2018, an impairment loss of $17·4m will be recorded:*

Dr	*Profit or loss*	*17.4*	
Cr	*Other investments*		*17·4*

Tutorial note: *If the investment had been classified at FVTOCI, the exchange loss would have been split into its two components; fair value loss and exchange rate loss.*

(5) Retained earnings

	$m	
Bravado:		
Balance at 31 March 2018	240	½
Associate profits (W3)	2·5	1
Foreign investment change in fair value (W4)	(17.4)	1
Increase in fair value of Clarity now realised	1	1
Write down of inventory (W8)	(18)	1
Increase in fair value of equity interest – Mixted (15 – 10)	5	1
Gain on bargain purchase (W1)	14	1½
Increase in fair value of contingent consideration	(1)	1
Post-acquisition reserves: Message	11·2	1
Mixted	16·5	1
	253.8	10

Message:	
Post-acquisition reserves (150 – 136) i.e. $14m	
Group reserves – 80%	11·2
Non-controlling interest – 20%	2·8
	14

Mixted:	
Post-acquisition reserves:	
At 31 March 2017 (80 – 55)	25
Less: Increase in depreciation (W9)	(2)
Add: Deferred tax movement (2 (increase in depreciation) × 30%)	0·6
	23·6
Group reserves – 70%	16·5
Non-controlling interest – 30%	7·1
	23·6

	$m	
Bravado: other components of equity		
Balance at 31 March 2018	12	½
Investment in associate (W3)	(1)	1
	11	1½

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(6) Current liabilities – trade payables

	$m	
Balance at 31 March 2018		
Bravado	115	
Message	30	
Mixted	60	
	205	
Contingent consideration	13	1
	218	

(7) Non-controlling interest

	$m	
Message – Fair value on acquisition	86	½
Post-acquisition reserves (W5)	2·8	1
	88·8	
Mixted Fair value on acquisition	53	½
Post-acquisition reserves (W5)	7·1	1
	60·1	
Total	148·9	
		3

(8) Inventories

Tutorial note: *If the net realisable value (NRV) of inventory (i.e. estimated selling price less costs of completion and to sell) is less than cost, it must be written down to NRV (IAS 2).*

	$m	
Selling price of units	1,450	
Less: Selling costs	(10)	
NRV of finished goods	1,440	
Selling price of units at stage 1	950	
Less: Selling costs	(10)	
NRV of stage 1 WIP	940	
Write down		
200,000 units × (1,500 – 1,440)	12	1
100,000 units × (1,000 – 940)	6	1
	18	2

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(9) Property, plant and equipment (PPE)

	$m	$m	
Bravado	265		
Message	230		
Mixted	161		
		656	
Increase in value of land – Message (400 – 220 – 136 – 4)		40	1
Increase in value of PPE – Mixted (176 – 100 – 55 – 7)		14	1
Less: Increased depreciation (14 ÷ 7)		(2)	1
		708	3

(10) Other investments

	$m	$m
Bravado	51	
Message	6	
Mixted	5	
		62
Less: Fall in fair value (W4)		(17·4)
		44·6

(11) Deferred tax

	$m	$m	
Bravado	25		
Message	9		
Mixted	3		
		37	
Arising on acquisition		3	1
Movement to year end (W5)		(0·6)	1
		39·4	2

(b) Message

Gain on bargain purchase if proportionate interest method is used:

	$m	
Consideration	300	½
Identifiable net assets	(400)	½
Non-controlling interest (20% × 400)	80	½
Gain on bargain purchase	(20)	

Discussion max4

The gain on bargain purchase has increased from $14 million to $20 million, this is due to the fact that non-controlling interest have been valued at a lower amount by $6 million.

This difference in valuation in non-controlling interest causes the gain to increase by the same amount, all of the increase in the gain is recognised by Bravado and none of the gain is credited to non-controlling interest.

It would have been more appropriate to measure non-controlling interest at fair value of the identifiable net assets in this instance as this would have led to a larger credit to profit or loss on the bargain purchase; it seems illogical to reduce the gain by measuring non-controlling interest at fair value.

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As IFRS 3 allows a choice in measuring non-controlling interest for each separate acquisition, it would have been better if Bravado had used fair value of identifiable net assets.

	$m	
Mixted:		
Purchase consideration	145	½
Identifiable net assets less deferred tax		
(170 initial fair value + 6 additional fair value – 3 deferred tax)	(173)	1
Non-controlling interest (30% × 173)	51·9	½
Goodwill	23·9	

Discussion max 4

The measurement of non-controlling interest is based on the identifiable net assets which have been valued at $173 million, non-controlling interest do not take a share of any goodwill.

The difference in the valuation of non-controlling interest between the two models is $1.1 million and this is also the difference in the two valuations of goodwill. In effect this comparison identifies that the value of goodwill attached to non-controlling interest is $1.1 million out of a total of $25 (part (a) W2).

On acquisition, the consolidated statement of financial position includes 100% of the subsidiary's net assets measured at fair value; if goodwill is to be recognised as an asset, it may be argued that the amount of goodwill recognised should also be 100%, thereby allocating a share of the goodwill to the non-controlling interest.

max 8

(c) Loan classification

Showing a loan as cash and cash equivalents is misleading. According to the *Conceptual Framework,* financial statements should have certain fundamental qualitative characteristics:

- relevance; and ½
- faithful representation.

In order to faithfully represent transactions and events, information must have the following characteristics:

- completeness; ½
- free from error; and
- neutrality.

These concepts preclude showing the directors' loans in cash. Such information needs separate disclosure as the financial statements must faithfully represent the events that have occurred in the period. Including a loan in cash and cash equivalents does not faithfully represent the fact that cash has been lent to another party; if the loan had been made to an external party, that fact would have been shown in the statements, therefore a loan to a director must be treated in exactly the same way. IAS 7 *Statement of Cash Flows* defines cash as cash that is on hand and demand deposits. As the loan is repayable on demand, there is an argument for treating it as a demand deposit; however, the substance of the transaction must be identified and disclosed. Even if the loan meets the definition of cash, it is highly likely that a management commentary statement, albeit voluntary, should disclose the loan to the director. Information must be free from bias and faithfully represent transactions. Representing the loan as cash would not be neutral and it could be seen as an error in the financial statements.

max 3

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Directors are responsible for the statutory financial statements and, if they believe that they do not comply with IFRS, they should take all steps to ensure that the error or irregularity is rectified. Every director will be deemed to have knowledge of the content of the financial statements. In some countries loans to directors are illegal and directors can be held personally liable. max 2

Directors have a responsibility to act honestly and ethically and not be motivated by personal interest and gain. If the ethical conduct of the directors is questionable then other areas of the financial statements may need scrutiny. 1

A loan of this nature could create a conflict of interest as the directors' personal interests may interfere or conflict with the company's interests. The accurate and full recording of business activities is essential to fulfil the financial and legal obligations of a director as is the efficient use of corporate assets. The loan to a director may conflict with this if, for example, it is interest-free. max 2

Directors have a legal duty of stewardship; they are responsible to the shareholders for their investments. It could be argued that lending money to directors is not making the best use of the company's funds, albeit Bravado does appear to be cash rich. 1

It is highly likely that the director would fall within the definition of key management personnel under IAS 24 *Related Party Disclosures;* if that is the case, any transactions between Bravado and its directors must be disclosed. Information relating to the loan must therefore be included in the disclosure notes, ensuring that the financial statements faithfully represent the events and transactions that have occurred in the period. max 2

max 7

50

2 ARGENT

Tutorial note: *The question requires discussion of relevant points. Relevant points that are not included in the solution should also be awarded equivalent marks.*

The International Accounting Standards Board (IASB) has undertaken the task of moving national GAAPs towards international accounting standards. It is a difficult task especially as the changes from national GAAP to international standards are often quite significant. The main problem from Argent's viewpoint is the degree of change that will affect the corporate financial statements. It should also be noted that as there is some difficulty in the repatriation of funds from Argon, a question of control must be raised; it may be argued that Argon is not a subsidiary of Argent. 2 for relevant intro

IAS 21 *The Effects of Changes in Foreign Exchange Rates* does not permit the use of the closing rate to translate income and expense items. Instead the rate of exchange at the date of the transaction should be used although an average rate for the period is acceptable. Under IAS 21 goodwill is to be treated as an asset of the foreign entity and as such should be translated at the closing rate. This will affect the amount of goodwill recognised in the reporting currency and will lead to recognition of an exchange difference in other comprehensive income for goodwill. Argent will also need to determine which currency it is going to use to measure the items in its financial statements (functional currency) and which currency it will use to present them in the financial statements (presentation currency). Argent would not have a free choice, IAS 21 requires the functional currency of an entity to be that which reflects the currency of the primary economic environment in which the entity operates, which in Argon's case is probably not the US dollar. The implication of this change is that Argon may be susceptible to exchange rate movements that would affect reported profits. max 3 for relevant discussion

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At this stage Argon can report these results in any currency that it wishes (called the presentational currency). Argon's valuation policy for non-current assets is unacceptable under IAS 16, as the standard requires the use of qualified valuers for property, which one assumes that the chief accountant is not. 1

There is a fundamental difference of principle between IAS 16 and local GAAP. Where the company opts for a policy of revaluation, IAS 16 requires revaluation to fair value whereas at present the company utilises a policy of revaluation to current value. Using "existing use value" for the properties is in accordance with local GAAP. IAS 16 states that the fair value of land and buildings is measured in accordance with IFRS 13 *Fair Value Measurement*. The fair value of a non-financial asset takes into account a market participant's ability to generate economic benefits from the asset for its highest and best use or by selling it to another market participant that would make the highest and best use of it (IFRS 13). This valuation will take into account the assets combination with other assets in a group, if relevant. max 2

Both local GAAP and IAS 16 expect that if a policy of revaluation is adopted, asset valuations should be reasonably current at the end of each reporting period. Local GAAP requires three-yearly full valuations by an external valuer but IAS 16 does not specify a maximum period between valuations. IAS 16 simply requires that valuations should be undertaken as frequently as is necessary; so the carrying amount of the asset should not differ materially from its fair value. The requirements and guidance in respect of the basis of valuations are not as detailed as many local GAAPs. It is likely that the information presented under IFRS will be of much more relevance to users of the financial statements, allowing them to make decisions about the future of the company. Finally, the reporting of revaluation gains under IFRS is different to that of local GAAP. IFRS does not allow revaluation gains to be recognised in profit or loss, the gain is taken to a revaluation surplus in equity. IFRS does allow the realisation of this gain to be recognised in retained earnings but does not allow the reclassification into profit or loss. Therefore reported earnings would be lower under IFRS in the year in which local GAAP allows the inclusion of the gain in profit or loss. The only gain IFRS allows is the difference between the sale proceeds and the carrying amount of the asset, if a profit has been made. max 4

The accounting policy adopted for the agreements relating to the energy contracts does not meet the requirements of IFRS 15 *Revenue from Contracts with* Customers. As Argent is purchasing the energy contracts with the intent of selling as a trading activity, they should be treated as inventory and included in current assets; a disclosure note should identify the remaining life of the energy contracts. As the contracts appear to be for a long period of time, it is likely that the performance obligations arising will be satisfied over a period of time. In this situation, revenue should not be recognised on signing of the contract, but on a proportionate basis using either an input (based on costs) or an output (based on revenue) method. Under IFRS, revenue will be recognised later than under local GAAP resulting in a bottom line profit that is lower than that previously recognised. max 2

The preference shares would be treated as debt under IFRS and any dividend classified as interest. The shares would be a financial liability, not a component of equity, which would be recognised initially at $20 million. Subsequently the liability would be "wound up" to include the redemption premium of $4 million, using the effective interest rate for the instrument; at the redemption date, the amount recognised would be $24 million. The increase of $4 million is a finance cost that will be expensed to profit or loss over the term of the instrument. This will result in lower reported profits under IFRS, as the interest is now an expense rather than a dividend (appropriation of profit). max 2

Also IAS 10 *Events after the Reporting Period* states that proposed dividends should not be recognised as a liability. A dividend should only be recognised when it becomes an actual liability. This requirement could conflict with the present legal requirements. IAS 10 emphasises this treatment by reinforcing the language used in IFRS. IAS 1 *Presentation of Financial Statements* also requires that the dividend is presented in the statement of changes in equity and not in the statement of profit or loss and other comprehensive income. 1

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Additionally, IAS 33 *Earnings per Share* does not allow "additional" earnings per share (EPS) calculations to be shown on the statement of profit or loss and other comprehensive income. Therefore, the EPS figures based upon EBITDA will have to be shown in the notes to the financial statements. 1

Under IFRS 9 *Financial Instruments* derivative financial instruments must be recognised in the financial statements, unlike the current accounting practice, when the company becomes a party to the contractual provisions of the instrument. All financial assets and liabilities are recognised in the statement of financial position including derivatives. Additionally the company would need to determine which of the financial instruments qualify for hedge accounting as there are conditions to be met as regards their effectiveness and documentation. The hedging relationship will also need to be defined. It is unlikely that the hedging of the overseas profits of Argon will qualify for hedge accounting. A company must measure derivatives at fair value and recognise any changes in fair value in profit or loss. This change will affect reported profits with gains and losses now recognised in reported earnings. This will lead to volatility in profits year-on-year and could lead to fluctuations in Argent's share price. max 4

It can be seen that the move to IFRS will have a pronounced effect on the financial statements of Argent. The majority of the changes will result in a reduction in profits. The directors need to be aware of the changes and present them to users of financial statements in advance. If relevant markets are made aware of what will be happening in the future; the news will not come as a surprise and there should be less disruption in the running of the company. max 2

Professional marks, max 2

max **25**

3 WADER

(a) Share appreciation rights

Under the principles of IFRS 2 *Share-based Payment* the granting of share appreciation rights (SARs) to executives is a cash-settled share-based payment. 1

Cash-settled share-based payments create a liability in the statement of the financial position as they will ultimately be redeemed in cash. 1

The liability is recognised based on the fair value of the SAR at the reporting date and the expected number of rights which will vest. ½ + ½

Vesting means earning an entitlement. Vesting conditions could either be service conditions (i.e. completing a period of service) or performance conditions, which also requires certain performance targets to be met. 1

Under the principles of IFRS 2 this liability is built up over the vesting period. ½

Therefore the liability at 31 March 2018 is \$412,960 (2,000 × (200 – 10 – 5 – 7) × \$1·74 × $^{2}/_{3}$). 1

Since the rights are not exercisable until after 31 March 2019, the liability would be shown as a non-current liability. ½

The liability at 31 March 2017 is \$216,000 (2,000 × (200 – 10 – 10) × \$1·80 × $^{1}/_{3}$). 1

The charge to profit or loss in the year ended 31 March 2018 is \$196,960 – the difference between the closing liability (\$412,960) and the opening liability (\$216,000). This charge would be shown as staff costs and therefore an operating cost. 1

max 7

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(b) Car seat contract

IFRS 15 *Revenue from Contracts with Customers* requires that before revenue can be recognised five steps must be met; they are: 1

- Identify the contract with a customer;
- Identify the performance obligations in the contract;
- Determine the transaction price;
- Allocate the transaction price to the performance obligations in the contract; and
- Recognise revenue as the entity satisfies a performance obligation.

Wader has entered a contract to sell car seats, not an item of machinery. The machine is owned by Wader and should be accounted for under IAS 16 *Property, Plant and Equipment.* 1

It is presumed that the car seats will be delivered over the five years of the contract; therefore revenue will be recognised over that period. When a performance obligation is satisfied over time, either an input or an output method should be used to determine how much revenue to recognise (IFRS 15). It seems that an output method would be appropriate in this situation, based on the delivery of car seats to the customer. Revenue cannot be recognised in advance of the completion of the contract. 2

Once the machine has been completed and manufacture of the car seats has commenced then any depreciation of the machine can be included in the cost of constructing the car seat, this will be part of inventory cost until the revenue recognition criteria are met. 1

As there is no commitment to a minimum order from Vehiclex consideration must be given to whether the cost of the machinery will be recovered through the sale of car seats. If there is doubt about the recovery of the cost then the machine must be tested for impairment, either as a single asset or as part of a cash generating unit. 1

max 5

(c) Revaluation non-current assets

IAS 16 *Property, Plant and Equipment* requires the increase in the carrying amount of an asset to be credited to other comprehensive income and then to equity under the heading "revaluation surplus". The increase should be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss. If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease is debited to other comprehensive income and then to equity (revaluation surplus) to the extent of any credit balance existing in revaluation surplus in respect of that asset. max 2 for theory

The buildings would be accounted for as follows:

Year ended 31 March	*2017*	*2018*	
	$m	$m	
Cost/valuation	10	8	
Depreciation ($10m ÷ 20); ($8m ÷ 19)	(0·5)	(0·42)	½ + ½
	9·5	7·58	
Impairment to profit or loss	(1·5)		½
Reversal of impairment loss to profit or loss		1·42	1
Gain on revaluation – revaluation surplus		2	½
Carrying amount	8	11	

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The gain on revaluation in 2018 has been recognised in profit or loss to the extent of the revaluation loss charged in 2017 as adjusted for the additional depreciation. \$0·08 million (1·5 ÷ 19) that would have been recognised in 2018 had the opening balance been \$9·5 million, and the loss of \$1·5 million not been recognised. Although no tax information is given, the revaluation will create a temporary difference assuming that the tax base remains the same. A revaluation decrease will create a deductible temporary difference and a revaluation increase will create a taxable temporary difference.

max 2 for discussing accounting treatment

max 6

Alternative working for impairment loss reversal:

31 March 2018:

Carrying amount based on original historical cost = $10 \times {}^{2}/_{20}$ = 9 million

Carrying amount based on revalued amount = $8 \times {}^{18}/_{19}$ = 7.58 million

Therefore maximum reversal through profit or loss = 1.42 million

(d) Restructuring

A provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* can only be made in relation to the entity's restructuring plans where there is both a detailed formal plan in place and the plans have been announced to those affected. The plan should identify areas of the business affected, the impact on employees and the likely cost of the restructuring and the timescale for implementation. The restructuring should begin as soon as possible and be completed in a timeframe that makes significant changes to the plan unlikely. — 1

As a formal and detailed plan has been made by the board of Wader and letters outlining the plan have been sent to customers, suppliers and employees, the criteria of IAS 37 have been met and a restructuring provision should be recognised. The provision should only include direct expenditure arising from the restructuring. Such amounts do not include costs associated with on-going business operations. Costs of retraining staff or relocating continuing staff or marketing or investment in new systems and distribution networks, are excluded. A breakdown of the \$8 million would be needed to assess which costs can be included in the provision and which must be excluded. — max 2

The supply contract is an example of an executory contract which is outside the scope of IAS 37, unless the contract is onerous. An onerous contract is one where the costs of performing the contract exceed the benefits earned from the contract. This contract is onerous as no future benefit is to be received, yet Wader must still perform its obligations under the contract. — 1

Wader has the option to pay an immediate cancelation fee of \$2.4 million or to continue to pay the supplier \$1.5 million each year for the next two years; payments should be discounted to present value using an appropriate discount rate, in this case 5%. The present value of the two payments is \$2.789 million $((1.5 \div 1.05) + (1.5 \div 1.05^2))$, therefore a provision of \$2.4 million, as the least cost option, should be recognised for the onerous contract with the supplier. — max 2

max 5

For clarity and quality of presentation — max 2

25

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4 FAIR VALUE ACCOUNTING

(a) Reliability and measurement problems

IFRS 13 *Fair Value Measurement* defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". 1 definition

Prior to the issue of IFRS 13 there was no general consensus on what fair value was and where was the best place to get fair value. There was conflict between accounting standards about how to arrive at fair value, for example; one standard would require use of the most advantageous active market in measuring the fair value of a financial asset or liability when multiple markets exist whilst another standard would require use of the most relevant market. IAS 40 *Investment Property* includes a fair value model, but gives no detailed guidance on what that fair value should be. Thus there can be different approaches for estimating exit prices. Additionally valuation techniques and current replacement cost could be used. max 2 (history)

A hierarchy of fair value measurements conveys information about the nature of the information used in creating the fair values. For example, quoted prices (unadjusted) in active markets would provide better quality information than quoted prices for similar assets and liabilities in active markets which would provide better quality information than prices which reflect the reporting entity's own thinking about the assumptions that market participants would use in pricing the asset or liability. Enron made extensive use of what it called "mark-to-market" accounting which was based on valuation techniques and estimates. Although Level 1 inputs provide the most reliable information and should be used wherever possible, they can be very difficult to determine. max 2

IFRS 7 *Financial Instruments: Disclosure* introduced a hierarchy to the measurement of fair value in respect of financial instruments, going from level 1 (quoted prices in an active market for identical instruments) to level 3 (inputs that are not based on observable market data), this hierarchy has also been adopted in IFRS 13. max 2

Some companies, in order to effectively manage their businesses, have already developed models for determining fair values. Businesses manage their operations by managing risks. A risk management process often requires measurement of fair values of contracts, financial instruments, and risk positions. max 1

If markets were liquid and transparent for all assets and liabilities, fair value accounting clearly would give reliable information which is useful in the decision making process. However, because many assets and liabilities do not have an active market, the inputs and methods for estimating their fair value are more subjective and, therefore, the valuations are less reliable. max 2

Fair value estimates can vary greatly, depending on the valuation inputs and methodology used. Where management uses significant judgment in selecting market inputs when market prices are not available, reliability will continue to be an issue. max 1

Management can use significant judgment in the valuation process. Management bias, whether intentional or unintentional, may result in inappropriate fair value measurements and consequently misstatements of earnings and equity capital. Without reliable fair value estimates, the potential for misstatements in financial statements prepared using fair value measurements will be even greater. max 2

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As the variety and complexity of financial instruments increases, so does the need for independent verification of fair value estimates. However, verification of valuations that are not based on observable market prices is very challenging. Users of financial statements will need to place greater emphasis on understanding how assets and liabilities are measured and how reliable these valuations are when making decisions based on them.

max 2

As a result of the financial crisis, the use of fair values for financial instruments has been severely criticised by many. They argue that the requirement to fair value certain financial instruments was the root cause of the crisis. However, many others disagree with this view, believing that fair value accounting merely reflects the events and positions as they occur. A meeting of the G-20 group ratified the need for fair value but did state that measures need to be taken to make fair value easier to use and understand. In 2014, the IASB finalised IFRS 9 *Financial Instruments;* one of its aims is the simplification of accounting for financial instruments.

max 2

max 7

Additional disclosures

Fair values reflect point estimates and do not result in transparent financial statements. Additional disclosures are necessary to bring meaning to these fair value estimates. These disclosures might include key drivers affecting valuations, fair-value range estimates, and confidence levels. Another important disclosure consideration relates to changes in fair value amounts.

max 2

For example, changes in fair values on securities can arise from movements in interest rates, foreign-currency rates and credit quality, as well as purchases and sales from the portfolio. For users to understand fair value estimates, they must be given adequate disclosures about what factors caused the changes in fair value. It could be argued that the costs involved in determining fair values may exceed the benefits derived there from. When considering how fair value information should be presented in the financial statements, it is important to consider what type of financial information investors want. There are indications that some investors desire both fair value information and historical cost information. One of the issues affecting the credibility of fair value disclosures currently is that a number of companies include "health warnings" with their disclosures indicating that the information is not used by management. This language may contribute to users believing that the fair value disclosures lack credibility.

max 3

max 5

max 11

(b) Valuation components

(i) Decommissioning liability

1 mark per relevant comment to a max of 3 each part

A decommissioning provision that is required to be recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is measured on initial recognition at the best estimate of the expenditure required to settle the obligation at the reporting date; this is similar to fair value in accordance with IFRS 13. As the effect of the time value of money will be material, the amount of the provision is the present value of the future expense.

Where a quoted price for an identical, or similar, liability is not available (which will be the case with a decommissioning liability), it should be measured using a valuation technique from the point of view of the party that has the liability, Braymac in this case.

The most likely valuation technique would be the present value of future cash flows that Braymac would expect to incur in fulfilling the obligation. If Braymac chooses to transfer the obligation to another party, cash flows should include compensation that the buyer would expect for taking over the obligation.

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(ii) *Share options*

IFRS 2 *Share-based Payment* requires share options to be valued at fair value when granted but uses a slightly different definition of fair value than the one in IFRS 13. (IFRS 13 "scopes out" these transactions, deferring instead to the requirements of IFRS 2.)

IFRS 2 defines fair value as, "the amount for which an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length agreement".

As market prices are generally not available for share options granted to employees, the value of the options, at grant date, is estimated using an option pricing model. One of the most common option pricing models used to value share options is the "Black-Scholes option pricing model".

The fair value of the options is fixed at the grant date; even if the value of the options changes over time, this change is not subsequently incorporated in the measurement process.

(iii) *10,000 equity shares*

The equity shares purchased must be measured at fair value on acquisition. If the shares are listed on a recognised stock exchange, they will be valued using a level 1 input from the fair value hierarchy.

Level 1 inputs presumes that there is an active market for identical shares and that Braymac has access to the market place on the measurement date.

However, an issue in the valuation of the shares relates to the "unit of account". The valuation may be different if 10,000 shares were purchased one at a time (at one extreme) rather than as one batch of 10,000 shares. Buying in bulk may lead to a slightly cheaper valuation than buying the shares individually, as the market place may be different depending on the unit of account.

This issue has now been included in the IASB's post-implementation review of IFRS 13. The review asks interested parties for their views on how the standard is working and any suggestions for improvements. The IASB will be looking at feedback received in December 2017.

(iv) *New-born lambs*

IAS 41 *Agriculture* covers the measurement of biological assets; new-born lambs are an example. On birth, lambs are measured at fair value less any costs to sell. This may seem strange as no obvious costs have been incurred in producing them. However, there is a market for them.

According to IFRS 13, non-financial assets should be valued using the "highest and best use". This takes into account the use of the asset that is physically possible, legally allowable and financially feasible.

Fair value measurement assumes that the asset will be sold in the principal market for the asset (i.e. the market with the greatest volume and level of activity for the asset) or, if a principal market does not exist, the most advantageous market (i.e. the market that maximises the amount that would be received after taking account of transaction and transport costs).

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Q	Part	Topic	Study Text ref	RQB coverage	Commentary
1	(a)	Consolidated statement of financial position	17 – 22	Q37 Grange	■ Read the question very carefully, there is a lot of information and it is very easy to miss something. ■ Re acquisition of Message; there is a clue in note (i) that there is a gain on bargain purchase; other than that it is a basic consolidation of a subsidiary – ensure you practice F7 skills. ■ NCI to be valued at fair value, but they do not share any of the gain on bargain purchase, that is all attributable to parent. ■ Mixted is a step-acquisition going over the 50% control threshold. Pretend to sell initial 6% and then pretend to buy back the 70%. Revalue original 6% to fair value at date of step. ■ Go back and change the estimated value of PP&E; it is within the 12 month measurement period. ■ Clarity is fair value to equity accounting; again pretend to sell the 10% and then pretend to buy back 25%. ■ The foreign investment must be valued at fair value and retranslated each year end; any forex gain or loss is included in profit or loss. ■ Be methodical with workings and ensure that you x-ref them to your answer. Marks will be lost if the figures are not transferred to your solution.
	(b)	Recalculate goodwill	17 – 22	Q26 Trailer	■ This question requires recalculation and discussion; 4 marks for each. Ensure at least an explanation of what figures change, which should earn 2 marks. ■ Valuing NCI at proportionate share of identifiable net assets increases the gain due to parent as the value of NCI will be lower. ■ In terms of Mixted it will reduce the amount of goodwill on acquisition; any impairment would all be charged against retained earnings.

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Q	Part	Topic	Study Text ref	RQB coverage	Commentary
1	(c)	Ethical discussion	26	Q35 Issue	■ Apply common sense wherever possible; in most questions the scenario leads to a statement that questions whether ethical values have been undermined. ■ To earn a pass at least 5 good and relevant comments must be made. ■ Answer in bulleted points rather than essay style, but do not abbreviate your solution into basic bullet points, the points must be complete sentences. ■ Use any personal experience you may have of ethical issues you have encountered in your workplace. ■ Ask yourself "would you be happy with the treatment proposed"; if not then discuss what is wrong with it.
2		IAS 1, IFRS 15 Financial Instruments IAS 16 IAS 21	4 8 6 22	Q35 Issue Q36 Lockfine	■ This type of questions requires an analytical approach of the scenario. ■ Highlight the main issues on the question paper and consider if the treatment would be different under IFRS. ■ Use bulleted sentences to discuss the issues as they arise. ■ State if the local GAAP is different to IFRS and what would be the required change on adoption of IFRS. ■ The question does not require you to have knowledge of "local GAAP" so don't be put off on the initial reading. ■ There are no numbers to assist, so the discussion must be focused; do not waffle. ■ To pass the question you need at least 12 good and relevant points, there are enough issues within the scenario to gain 12 marks. ■ Be professional in your solution, make sure it is legible, and gain the 2 professional marks.

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Q	Part	Topic	Study Text ref	RQB coverage	Commentary
3	(a)	Share appreciation rights	15	Q23 Margie	■ Question requires a discussion and a calculation of the numbers. ■ SARs is a form of bonus paid to employees, in this case, based on the increase of the company's share price. ■ Calculate liability at end of current year and of the previous year. The difference is the expense for the year. ■ The scheme does not start to pay out until following year, therefore no cash flows to deal with.
	(b)	Revenue recognition	4	Q7(a) Havanna	■ Only 4 marks so do not get engrossed in detail. ■ Make mention of all the relevant standards, IAS 16, IAS 36 and IFRS 15. ■ Make a clear and concise statement relating to each of the above standards and be able to quote the 5 steps of revenue recognition.
	(c)	PP&E valuation	6	Q9 Scramble	■ Again presumed knowledge of previous studies required to answer question. ■ Calculate and discuss, as long as you tell the marker what your calculations represent you should pass the question. ■ Do not state everything you know about IAS 16; be specific to the scenario given. Answer the question set and do not "knowledge dump".
	(d)	Provisions, etc	13	Q21 Provisions	■ Again ensure any points raised are specific to the scenario. ■ Calculate the NPV of cash flows relating to onerous contract, the lower value will be recognised as a provision. ■ Discuss the actions taken and why a provision is required, or not, as the case may be. ■ Ensure solution is again professional in order to earn the 2 professional marks available.

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Q	Part	Topic	Study Text ref	RQB coverage	Commentary
4		Fair value accounting	3	Q4 Jayach	■ This type of question cannot be learnt, it requires application of the knowledge gained from studying the P2 syllabus. ■ Think logically and use common sense. ■ At least 6 relevant points must be made in order to pass part (a) and 6 points to pass part (b). ■ Part (a) requires knowledge of the issues surrounding fair value measurement, it is not just about knowledge of IFRS 13. ■ Part (b) requires application of knowledge to a number of transactions; note that standards other than IFRS 13 are also relevant. ■ Ensure solution is again professional in order to earn the 2 professional marks available.

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