Section A

1 Joey

Marking scheme

			Marks
(a)	(i)	Goodwill	
		Calculation	4
		Discussion – 1 mark per point up to maximum	6
			10
	(ii)	Asset held for sale	
		Calculation	3
		Discussion – 1 mark per point up to maximum	3
			6
	(iii)	Retained earnings	4
			20
(b)		Subjective assessment of discussion – 1 mark per point up to maximum	5
			25

(a) (i) **Goodwill**

IFRS 3 *Business Combinations* requires goodwill to be recognised in a business combination. A business combination takes place when one entity, the acquirer, obtains control of another entity, the acquiree. IFRS 3 requires goodwill to be calculated and recorded at the acquisition date. Goodwill is the difference between the consideration transferred by the acquirer, the amount of any non-controlling interest and the fair value of the net assets of the acquiree at the acquisition date. When the business combination is achieved in stages, as is the case for Margy, the previously held interest in the now subsidiary must be remeasured to its fair value.

Applying these principles, the goodwill on the acquisition of Hulty and Margy should be calculated as follows:

	Hulty		*Margy*	
	$m	$m	$m	$m
Consideration transferred		700		975
Non-controlling interest (at fair value)		250		620
Fair value of previously held equity interest (Note (i))				705
Less fair value of net assets at acquisition				
Share capital	600		1,020	
Retained earnings	300		900	
Other components of equity	40		70	
Fair value adjustments:				
Land (Note (ii) and W1)	–		266	
Contingent liability (Note (iii))	–		(6)	
Franchise right (W1)	20		–	
		(960)		(2,250)
Gain on bargain purchase (Note (iv))		(10)		50

	Hulty		*Margy*	
	$m	$m	$m	$m
Measurement period adjustments:				
Add decrease in FV of buildings (Note (v))				40
Contingent liability: $6m – $5m (Note (iii))				(1)
Goodwill				89

Notes

(i) Margy is a business combination achieved in stages, here moving from a 30% owned associate to a 70% owned subsidiary on 1 December 20X3. Substance over form dictates the accounting treatment as, in substance, an associate has been disposed of and a subsidiary has been purchased. From 1 December 20X3, Margy is accounted for as a subsidiary of Joey and goodwill on acquisition is calculated at this date. IFRS 3 requires that the previously held investment is remeasured to fair value and included in the goodwill calculation as shown above. Any gain or loss on remeasurement to fair value is reported in consolidated profit or loss.

(ii) IFRS 3 requires the net assets acquired to be measured at their fair value at the acquisition date. The increase in the fair value of Margy's net assets (that are not the result of specific factors covered in Notes (iii) and (v) below) is attributed to non-depreciable land.

(iii) In accordance with IFRS 3, contingent liabilities should be recognised on acquisition of a subsidiary where they are a present obligation arising as the result of a past event and their fair value can be measured reliably (as is the case for the warranty claims) even if their settlement is not probable. Contingent liabilities after initial recognition must be measured at the higher of the amount that would be recognised under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognised under IFRS 3.

(iv) As the goodwill calculation for the acquisition of Hulty results in a negative value, this is a gain on a bargain purchase and should be recorded in profit or loss for the year attributable to the parent. Before doing so, Joey must review the goodwill calculation to ensure that it has correctly identified all of the assets acquired and all of the liabilities assumed, along with verifying that its measurement of the consideration transferred and the non-controlling interest is appropriate. Joey has completed this exercise and thus it is appropriate to record the negative goodwill and related profit.

(v) As a result of the independent property valuation becoming available during the measurement period, the carrying amount of property, plant and equipment as at 30 November 20X4 is decreased by $40 million less excess depreciation charged of $2 million ($40m/20 years), ie $38 million. This will increase the carrying amount of goodwill by $40 million as IFRS 3 allows the retrospective adjustment of a provisional figure used in the calculation of goodwill at the acquisition date where new information has become available about the circumstances that existed at the acquisition date. Depreciation expense for 20X4 is decreased by $2 million.

Workings

1 *Hulty: Fair value adjustments*

	At acq'n 1 Dec 20X3 $m	*Movement (over 4 years)* $m	*At year end 30 Nov 20X4* $m
Franchise: 960 – (600 + 300 + 40)	20	(5)	15

2 *Margy: Fair value adjustments*

	At acq'n 1 Dec 20X3 $m	*Movement (reduced dep'n)* $m	*At year end 30 Nov 20X4* $m
Land: 2,250 – (1,020 + 900 + 70) + 6*	266	–	266
Property, plant & equipment	(40)	2	(38)

*Contingent liability

(ii) **Asset held for sale**

At 31 March 20X4, the criteria in IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations* have been met, and the property should be classified as held for sale. In accordance with IFRS 5, an asset held for sale should be measured at the **lower of** its **carrying amount** and **fair value less costs to sell**. Immediately before classification of the asset as held for sale, the entity must recognise any impairment in accordance with the applicable IFRS. Any impairment loss is generally recognised in profit or loss. The steps are as follows:

Step 1 Calculate carrying amount under applicable IFRS, here IAS 16 *Property, Plant and Equipment*:

At 31 March 20X4, the date of classification as held for sale, depreciation to date is calculated as $300,000 × 4/12 = $100,000. The carrying amount of the property is therefore $13.9 million ($14.0 – $0.1m). The journal entries are:

DEBIT	Profit or loss ((a) (iii))	$0.1m	
CREDIT	Property, Plant & Equipment (PPE)		$0.1m

The difference between the carrying amount and the fair value at 31 March 20X4 is material, so the property is revalued to its fair value of $15.4 million under IAS 16's revaluation model:

DEBIT	PPE ($15.4m – $13.9m)	$1.5m	
CREDIT	Other comprehensive income		$1.5m

Step 2 Consider whether the property is impaired by comparing its carrying amount, the fair value of $15.4 million, with its recoverable amount. The recoverable amount is the higher of value in use (given as $15.8 million) and fair value less costs to sell ($15.4m – $3m = $15.1m.) The property is not impaired because the recoverable amount (value in use) is higher than the carrying amount (fair value). No impairment loss is recognised.

Step 3 Classify as held for sale and cease depreciation under IFRS 5. Compare the carrying amount ($15.4 million) with fair value less costs to sell ($15.1 million). Measure at the lower of carrying amount and fair value less costs to sell, here $15.1 million, giving an initial write-down of $300,000.

DEBIT	Profit or loss ((a) (iii))	$0.3m	
CREDIT	PPE		$0.3m

Step 4 On 30 November 20X4, the property is sold for $15.6 million, which, after deducting costs to sell of $0.3 million gives a profit or $0.2 million.

DEBIT	Receivables	$15.3m	
CREDIT	PPE		$15.1m
CREDIT	Profit or loss ((a) (iii))		$0.2m

(iii) **Retained earnings**

JOEY GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 NOVEMBER 20X4 (EXTRACT)

	$m
Retained earnings (W1)	3,451.7

Workings

W1: Group retained earnings

	Joey	*Hulty*	*Margy*
	$m	$m	$m
At year end	3,340.0	350	980
FV adjustment: dep'n reduction ((a) (i))			2
FV adjustment: franchise amortisation ((a) (i))		(5)	
Liability adjustment (6–1)* ((a) (i))			5
Gain on bargain purchase ((a) (i))	10.0		
Profit on derecognition of associate (W2)	5.0		
Asset held for sale: (0.2 – 0.1 – 0.3) ((a) (ii))	(0.2)		
At acquisition ((a) (i))		(300)	(900)
		45	87
Group share:			
Hulty: 80% × 45	36.0		
Margy: 70% × 87	60.9		
	3,451.7		

** The warranty claim provision of $5 million in Margy's financial statements must be reversed on consolidation to avoid double counting. This is because the contingent liability for this warranty claim was recognised in the consolidated financial statements on acquisition of Margy.*

W2: Profit on derecognition of 30% associate

	$m
Fair value of previously held equity interest at date control obtained (per question / ((a) (i))	705
Carrying amount of associate: 600 cost + 90 (post-acq'n RE) + 10 (post acq'n OCE)	(700)
Profit	5

(b) **Share-based payment**

This arrangement will be governed by IFRS 2 *Share-based Payment,* which includes within its scope **transfers of equity instruments of an entity's parent in return for goods or services.** Clear guidance is given in the Standard as to **when to treat group share-based payment transactions as equity settled and when to treat them as cash settled.**

To determine the accounting treatment, the group entity receiving the goods and services must **consider its own rights and obligations as well as the awards granted.** The amount recognised by the group entity receiving the goods and services will not necessarily be consistent with the amount recognised in the consolidated financial statements.

Group share-based payment transactions **must be treated as equity settled** if either of the following apply:

(i) The entity **grants rights to its own equity instruments**.
(ii) The entity has **no obligation to settle** the share-based payment transactions.

Treatment in consolidated financial statements

Because the group receives all of the services in consideration for the group's equity instruments, the transaction is treated as **equity settled**. The fair value of the share-based payment at the grant date is **charged to profit or loss over the vesting period with a corresponding credit to equity.** In this case, the options vest immediately on the grant date, the employees not being required to complete a specified period of service and the services therefore being presumed to have been received. The fair value will be taken by reference to the market value of the shares because it is deemed not normally possible to measure directly the fair value of the employee services received.

Treatment in subsidiaries' financial statements

The subsidiaries do not have an obligation to settle the awards, so the grant is treated as an **equity settled** transaction. The fair value of the share-based payment at the grant date is **charged to profit or loss over the vesting period with a corresponding credit to equity.** The parent, Joey, is compensating the employees of the subsidiaries, Margy and Hulty, with no expense to the subsidiaries, and therefore the **credit in equity is treated as a capital contribution**. Because the shares vest immediately, the expense recognised in Margy and Hulty's statement of profit or loss will be the full cost of the fair value at grant date.

IAS 24 disclosures

Some of the employees are considered **key management personnel** and therefore IAS 24 *Related Party Disclosures* should be applied. IAS 24 requires disclosure of the related party relationship, the transaction and any outstanding balances at the year end date. Such disclosures are required in order to provide sufficient information to the users of the financial statements about the potential impact of related party transactions on an entity's profit or loss and financial position. IAS 24 requires that an entity discloses key management personnel compensation in total and for several categories, of which share-based payments is one.

2 Jogger

Marking scheme

		Marks
(a)	Discussion 1 mark per point to a maximum	8
(b)	Reporting EBITDA advantages and disadvantages	5
	Description of management of earnings	5
	Moral/ethical considerations	5
		15
Professional marks		2
		25

(a) **Social and environmental information**

There are a number of factors which encourage companies to disclose social and environmental information in their financial statements. **Public interest** in corporate social responsibility is steadily increasing. Although financial statements are primarily intended for present and potential investors, lenders and other creditors, there is growing recognition that companies actually have **a number of different stakeholders**. These include **customers, employees and the general public,** all of whom are **potentially interested** in the way in which a company's operations affect the natural environment and the wider community. These stakeholders can have a **considerable effect on a company's performance**. As a result, many companies now deliberately attempt to build a **reputation for social and environmental responsibility**. Therefore, the disclosure of environmental and social information is essential. There is also growing recognition that **corporate social responsibility is actually an important part of an entity's overall performance**. Responsible practice in areas such as reduction of damage to the environment and recruitment **increases shareholder value**. Companies that act responsibly and make social and environmental disclosures are **perceived as better investments** than those that do not.

Another factor is **growing interest by governments and professional bodies**. Although there are **no IFRSs** that specifically require environmental and social reporting, it may be required by **company legislation**. There are now a number of **awards for environmental and social reports** and high quality disclosure in financial statements. These provide further encouragement to disclose information.

At present companies are normally able to disclose **as much or as little information as they wish in whatever manner that they wish**. This causes a number of **problems**. Companies tend to disclose information **selectively** and it is difficult for users of the financial statements to **compare the performance of different companies**. However, there are **good arguments** for continuing to allow companies a certain amount of freedom to determine the information that they disclose. If detailed rules are imposed, **companies are likely to adopt a 'checklist' approach** and will **present information in a very general and standardised way**, so that it is of very little use to stakeholders.

(b) **EBITDA and the management of earnings**

EBITDA is a widely used measure of corporate earnings, but it is also a controversial figure. EBITDA attempts to show earnings before tax, depreciation and amortisation. Depreciation and amortisation are expenses that arise from historical transactions over which the company now has very little control, and are often arbitrary in nature as they involve subjectivity in estimating useful lives and residual values. As they are non-cash, it is argued that they do not have any real impact on a company's operations. Companies also argue that they are not in control of tax and it should therefore not be a component of earnings. Interest is the result of financing decisions which are also often historic and influenced by a company's financing decisions. EBITDA is said to eliminate the effect of financing and accounting decisions and therefore gives investors and potential investors better insight into the performance of management and the impact of management decisions.

There are, however, criticisms of EBITDA. The main criticism is that EBITDA is not defined in IFRS and therefore is open to manipulation as companies can choose which items to include/exclude from its calculation. The fact that EBITDA is not defined can also reduce its usefulness to investors and potential investors as comparisons with previous years or to other companies may not be meaningful.

The managing director is proposing EBITDA is managed to report Jogger in a favourable light. 'Earnings management' involves exercising judgement with regard to financial reporting and structuring transactions so as to give a **misleadingly optimistic picture** of a company's

performance. Commonly it involves manipulating earnings in order to meet a target predetermined by management.

Earnings management can take place in respect of reported profit under IAS 1, or in alternative performance measures such as EBITDA is as suggested here. Earnings management is done with the intention, whether consciously or not, of **influencing outcomes that depend on stakeholders' assessments**. It is the **intent** to deceive stakeholders that is unethical even if the earnings management remains within the acceptable boundaries of GAAP. For example, a potential investor may decide to invest in a company or an existing investor may be encouraged to increase their shareholding on the basis of a favourable performance or position. A director may wish to delay a hit to profit or loss for the year in order to ensure a particular year's results are well received by investors, or to secure a bonus that depends on profit. Indeed earnings management, sometimes called 'creative accounting', may be described as manipulation of the financial reporting process for private gain.

The directors may also wish to present the company favourably in order to maintain a **strong position within the market**. The motive is not always private gain – he or she may be thinking of the company's stakeholders, such as employees, suppliers or customers – but in the long term, earnings management is not a substitute for sound and profitable business, and cannot be sustained. In this case, the financial controller has been reminded that he will receive a substantial bonus if earnings targets are met. This represents a self-interest threat under ACCA's *Code of Ethics and Conduct* as the financial controller will personally benefit from the management of earnings. The 'reminder' from the managing director could also be interpreted as an intimidation threat if the financial controller feels unduly pressured as a result of the statement.

'Aggressive' earnings management is a form of fraud and differs from reporting error. Nevertheless, all forms of earnings management may be **ethically questionable**, even if not illegal.

The flexibility allowed by IFRSs may cause some variability to occur as a result of the accounting treatment options chosen, but the accounting profession has a responsibility to provide a framework that does not encourage earnings management. For example, the old standard on revenue, IAS 18, was criticised for vagueness and inconsistency in its guidance on the timing of revenue recognition allowing scope for earnings management, allowing directors to act unethically by adopting inappropriate accounting policies to boost revenue. For example, a company's revenue recognition policy could result in improper matching of income and expenses for a transaction, with the income accelerated into the current period while the expenses are accounted for in a future period. The IASB issued IFRS 15 *Revenue from Contracts with Customers* in response.

A more positive way of looking at earnings management is to consider the **benefits of not manipulating earnings:**

(i) Stakeholders can rely on the data. Word gets around that the company 'tells it like it is' and does not try to bury bad news.

(ii) It encourages management to safeguard the assets and exercise prudence.

(iii) Management set an example to employees to work harder to make genuine profits, not arising from the manipulation of accruals.

(iv) Focus on cash flow rather than accounting profits keeps management anchored in reality.

Earnings management goes against **the principle of corporate social responsibility**. Companies have a duty not to mislead stakeholders, whether their own shareholders, suppliers, employees or the government. Because the temptation to indulge in earnings management may be strong, particularly in times of financial crisis, it is important to have **ethical frameworks** (such as ACCA's *Code of Ethics and Conduct*) **and guidelines** in place. The letter of the law may not be enough.

Section B

3 Klancet

Marking scheme

			Marks
(a)	(i)	Requirements of IFRS 8 – 1 mark per point up to maximum	6
	(ii)	Usefulness of IFRS 8 – 1 mark per point up to maximum	5
	(iii)	Impact of Disclosure Initiative – 1 mark per point up to maximum	4
(b)		Notes for presentation – 1 mark per point up to maximum	8
			2
Professional marks (part (a))			25

(a) (i) **Segment reporting**

IFRS 8 *Operating Segments* states that an operating segment is a component of an entity which engages in business activities from which it may earn revenues and incur costs. In addition, discrete financial information should be available for the segment and these results should be regularly reviewed by the entity's chief operating decision maker (CODM) when making decisions about resource allocation to the segment and assessing its performance.

Other factors should be taken into account, including the nature of the business activities of each component, the existence of managers responsible for them, and information presented to the board of directors.

According to IFRS 8, an operating segment is one which meets any of the following quantitative thresholds:

(i) Its reported revenue is 10% or more of the combined revenue of all operating segments.

(ii) The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of (1) the combined reported profit of all operating segments which did not report a loss and (2) the combined reported loss of all operating segments which reported a loss.

(iii) Its assets are 10% or more of the combined assets of all operating segments.

As a result of the application of the above criteria, the first laboratory will not be reported as a separate operating segment. The divisions have heads directly accountable to, and maintaining regular contact with, the CODM to discuss all aspects of their division's performance. The divisions seem to be consistent with the core principle of IFRS 8 and should be reported as separate segments. The laboratory does not have a separate segment manager and the existence of a segment manager is normally an important factor in determining operating segments. Instead, the laboratory is responsible to the divisions themselves, which would seem to indicate that it is simply supporting the existing divisions and not a separate segment. Additionally, there does not seem to be any discrete performance information for the segment, which is reviewed by the CODM.

The second laboratory should be reported as a separate segment. It meets the quantitative threshold for percentage of total revenues and it meets other criteria for an operating segment. It engages in activities which earn revenues and incurs costs, its

operating results are reviewed by the CODM and discrete information is available for the laboratory's activities. Finally, it has a separate segment manager.

(ii) Contrary to the managing directors' views, IFRS 8 provides information that makes the financial statements more relevant and more useful to investors. IFRS financial statements are highly aggregated and may prevent investors from understanding the many different business areas and activities that an entity is engaged in. IFRS 8 requires information to be disclosed that is not readily available elsewhere in the financial statements, therefore it provides additional information which aids an investor's understanding of how the business operates and is managed.

IFRS 8 uses a 'management approach' to report information on an entity's segments and results from the point of view of the decision makers of the entity. This allows investors to examine an entity 'though the eyes of management' – to see the business in the way in which the managers who run the business on their behalf see it. This provides investors with more discrete information on the business segments allowing them to better assess the return being earned from those business segments, the risks that are associated with those segments and how those risks are managed. The more detailed information provides investors with more insight into an entity's longer term performance.

The requirement to disclose information that is actually used by internal decision makers is an important feature of IFRS 8, but is also one of its main criticisms. The fact that the reporting does not need to be based on IFRS makes it difficult to make comparisons with information that was reported in prior periods and with other companies in the sector. The flexibility in reporting can make it easier to manipulate what is reported. IFRS 8 disclosures are often most useful if used in conjunction with narrative disclosures prepared by the directors of the company, such as the Strategic Review in the UK.

(iii) The IASB's Disclosure Initiative is a series of projects which are focused on how presentation and disclosure can be improved. The discussion paper *Disclosure Initiative – Principles of Disclosure* refers to improvements to IFRS 8 proposed in an exposure draft issued in March 2017. One proposed improvement is to define an entity's 'annual reporting package' as a publicly available set of one or more documents that are published at approximately the same time as the financial statements, and which communicate annual results to the users of financial information. This is a broader term than annual report or financial statements, as these terms are currently used. The ED proposes that the entity is expected to identify the same reportable segments throughout all of its annual reporting package. If this is not the case, then the entity should explain why.

The improvement has been proposed because it seems that some entities are identifying different reportable segments in their financial statements compared to other reports such as the Business Review published at a similar time. This practice is understandably confusing to investors because the identification of reportable segments in IFRS 8 is based on what management uses to make decisions and should therefore reflect how the business is actually managed.

The IASB is considering whether to use the term 'annual reporting package' in its consultations on the principles of disclosure. Specifically whether IFRS required disclosure can be presented in another part of the annual reporting package and cross referenced to the financial statements.

(b) **Development of drugs**

Notes for presentation to the managing director

1 **Criteria for recognising as an asset**

IAS 38 *Intangible Assets* requires an entity to recognise an intangible asset, whether purchased or self-created (at cost) if, and only if, it is probable that the future economic

benefits which are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably.

The *Conceptual Framework* defines an asset as 'a resource controlled by an entity as a result of past events from which future economic benefits are expected to flow to the entity' (para. 4.4(a)).

The Exposure Draft ED/2015/3 *Conceptual Framework for Financial Reporting* proposes to change the definition of an asset to 'a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits' (ED/2015/3; Chapter 4).

There is therefore inconsistency in the terminology used by IAS 38 and the *Conceptual Framework* in that IAS 38 refers 'probable economic benefits' and the *Conceptual Framework* says that economic benefits are 'expected' to flow. Neither probable nor expected is defined in IFRSs and therefore there is potential for confusion as to whether the threshold for recognising the future benefits is consistent. The term 'the potential to produce economic benefits' used by the Exposure Draft does not provide any further clarity and therefore the terminology remains inconsistent. There are currently no plans to amend IAS 38 for consistency with the revised *Conceptual Framework*.

2. Internally generated intangible assets

The recognition requirements of IAS 38 apply whether an intangible asset is acquired externally or generated internally. IAS 38 includes additional recognition criteria for internally generated intangible assets.

Development costs are capitalised only after technical and commercial feasibility of the asset for sale or use have been established. This means that the entity must intend and be able to complete the intangible asset and either use it or sell it and be able to demonstrate how the asset will generate future economic benefits, in keeping with the recognition criteria.

If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure for that project as if it were incurred in the research phase only.

The price which an entity pays to acquire an intangible asset reflects its expectations about the probability that the expected future economic benefits in the asset will flow to the entity.

3. Project 1

Klancet owns the potential new drug, and Retto is carrying out the development of the drug on its behalf. The risks and rewards of ownership remain with Klancet.

By paying the initial fee and the subsequent payment to Retto, Klancet does not acquire a separate intangible asset. The payments represent research and development by a third party, which need to be expensed over the development period provided that the recognition criteria for internally generated intangible assets are not met.

Development costs are capitalised only after technical and commercial feasibility of the asset for sale or use have been established. This means that the entity must intend and be able to complete the intangible asset and either use it or sell it and be able to demonstrate how the asset will generate future economic benefits. At present, this criterion does not appear to have been met as regulatory authority for the use of the drug has not been given and, in fact, approval has been refused in the past.

4. Project 2

In the case of the second project, the drug has already been discovered and therefore the costs are for the development and manufacture of the drug and its slight modification. There is no indication that the agreed prices for the various elements are

not at fair value. In particular, the terms for product supply at cost plus profit are consistent with Klancet's other supply arrangements.

Therefore, Klancet should capitalise the upfront purchase of the drug and subsequent payments as incurred, and consider impairment at each financial reporting date. Regulatory approval has already been attained for the existing drug and therefore there is no reason to expect that this will not be given for the new drug. Amortisation should begin once regulatory approval has been obtained. Costs for the products have to be accounted for as inventory using IAS 2 *Inventories* and then expensed as costs of goods sold as incurred.

4 Jayach

Marking scheme

		Marks
(a)	1 mark per point up to maximum	8
(b)	1 mark per point up to maximum	6
	Calculations	5
		11
(c)	1 mark per point up to maximum	6
		25

(a) **IFRS 13 principles of fair value measurement**

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**' (para. 9).

Fair value is a **market-based measurement,** not an entity-specific measurement. It **focuses on assets and liabilities and on exit (selling) prices**. It takes into account market conditions at the measurement date. In other words, it looks at the amount for which the holder of an asset could sell it and the amount which the holder of a liability would have to pay to transfer it. It can also be used to value an entity's own equity instruments.

It is assumed that the transaction to sell the asset or transfer the liability takes place either:

(1) In the **principal market** for the asset or liability; or

(2) In the absence of a principal market, in the **most advantageous market** for the asset or liability.

The **principal market** is the market which is the **most liquid** (has the greatest volume and level of activity for that asset or liability). The **most advantageous market** is the market which **maximises** the value of an **asset** or **minimises** the **amount** that would be **required to transfer a liability**. In most cases the principal market and the most advantageous market will be the same.

For **non-financial assets**, the fair value measurement is the value for using the asset in its **highest and best use** (the use that would maximise its value) or by selling it to another market participant that would use it in its highest and best use. The **fair value of liabilities** should **reflect the non-performance risk** associated with that liability, ie the risk that the entity will not fulfil its obligation.

Fair value is **not adjusted for transaction costs.** Under IFRS 13, these are **not a feature of the asset or liability,** but may be taken into account when **determining the most advantageous market.**

Fair value measurements are based on an asset or a liability's **unit of account**, which is specified not by IFRS 13, but by each IFRS where a fair value measurement is required. For most assets and liabilities, the unit of account is the individual asset or liability, but in some instances may be a group of assets or liabilities.

IFRS 13 acknowledges that when **market activity declines**, an entity must use a **valuation technique** to measure fair value. In this case the emphasis must be on whether a transaction price is based on an orderly transaction, rather than a forced sale. The technique used must be appropriate in the circumstances and may therefore differ between entities.

The IFRS identifies **three valuation approaches**.

(1) **Market approach.** A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business.

(2) **Cost approach.** A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

(3) **Income approach.** Valuation techniques that convert future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

(b) **Fair value of asset**

YEAR TO 30 NOVEMBER 20X2	*Asian market*	*European market*	*Australasian market*
Volume of market – units	4m	2m	1m
	$	$	$
Price	19	16	22
Costs of entering the market	(2)	(2)	n/a*
Potential fair value	17	14	22
Transaction costs	(1)	(2)	(2)
Net profit	16	12	20

Notes

1 Because Jayach currently buys and sells the asset in the Australasian market, the **costs of entering that market** are not incurred and therefore **not relevant**.

2 Fair value is **not adjusted for transaction costs.** Under IFRS 13, these are not a feature of the asset or liability, but may be taken into account when determining the most advantageous market.

3 The **Asian market is the principal market** for the asset because it is the market with the greatest volume and level of activity for the asset. If information about the Asian market is available and Jayach can access the market, then Jayach should base its fair value on this market. Based on the Asian market, the **fair value of the asset would be $17**, measured as the price that would be received in that market ($19) less costs of entering the market ($2) and ignoring transaction costs.

4 If **information** about the Asian market is **not available**, or if Jayach **cannot access the market**, Jayach must measure the fair value of the asset using the price in the **most advantageous market**. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account both transaction costs and usually also costs of entry, which is the net amount that would be received in the respective markets. The most advantageous market here is therefore the **Australasian market**. As explained above, costs of entry are not relevant here, and so, based on this market, the **fair value would be $22**.

It is assumed that market participants are independent of each other and knowledgeable, and able and willing to enter into transactions.

Fair value of decommissioning liability

Because this is a business combination, Jayach must measure the liability at fair value in accordance with IFRS 13, rather than using the best estimate measurement required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* In most cases there will be no observable market to provide pricing information. If this is the case here, Jayach will use **the expected present value technique** to measure the fair value of the decommissioning liability. If Jayach were contractually committed to transfer its decommissioning liability to a market participant, it would conclude that a market participant would use the inputs as follows, arriving at a **fair value of $3,215,000**.

Input	*Amount*
	$'000
Labour and material cost	2,000
Overhead: 30% × 2,000	600
Third party mark-up – industry average: 2,600 × 20%	520
	3120
Inflation adjusted total (5% compounded over three years): 3,120 × 1.05^3	3,612
Risk adjustment – uncertainty relating to cash flows: 3,612 × 6%	217
	3,829
Discount at risk-free rate plus entity's non-performance risk (4% + 2% = 6%): $3,829/1.06^3$	3,215

(c) A 'mixed measurement' approach means that a company selects a different measurement basis for its various assets and liabilities, rather than using a single measurement basis for all items. The measurement basis selected should reflect the type of entity and sector in which it operates and the business model that the entity adopts.

Some investors have criticised the mixed measurement approach because they think that if different measurement bases are used for assets and liabilities, the resulting totals can have little meaning. Similarly, they believe profit or loss may lack relevance if it reflects a combination of transactions based on historical cost and of value changes for items measured on a current value basis.

However, a single measurement basis may not provide the most relevant information to users. Different information from different measurement bases may be relevant in different circumstances. A particular measurement basis may be easier to understand, more verifiable and less costly to implement. Therefore a mixed measurement approach is not 'inconsistent' but can actually provide more relevant information for stakeholders.

The IASB uses a mixed measurement approach where the measurement method selected is that which is most relevant and which most faithfully represents the information it represents. It seems that most investors feel that this approach is consistent with how they analyse financial

statements. The problems of mixed measurement appear to be outweighed by the greater relevance achieved.

Jayach prepares its financial statements under IFRSs, and therefore applies the measurement bases permitted in IFRSs. IFRSs adopt a mixed measurement basis, which includes fair value, historical cost, and net realisable value.

When an IFRS allows a choice of measurement basis, the directors of Jayach must exercise judgment as to which basis will provide the most relevant information for stakeholders. Furthermore when selecting a measurement basis, the directors should consider measurement uncertainty. The Exposure Draft on the *Conceptual Framework* states that for some estimates, a high level of measurement uncertainty may outweigh other factors to such an extent that the resulting information may have little relevance.