Section A – BOTH questions are compulsory and MUST be attempted

1 Joey

(a) Joey, a public limited company, operates in the media sector. Joey has investments in two companies, Margy and Hulty. The draft statements of financial position at 30 November 20X4 are as follows:

	Joey $m	*Margy* $m	*Hulty* $m
Assets			
Non-current assets			
Property, plant and equipment	3,295	2,000	1,200
Investments in subsidiaries			
Margy	1,675		
Hulty	700		
	5,670	2,000	1,200
Current assets	985	861	150
Total assets	6,655	2,861	1,350
Equity and liabilities			
Share capital	850	1,020	600
Retained earnings	3,340	980	350
Other components of equity	250	80	40
Total equity	4,440	2,080	990
Total liabilities	2,215	781	360
Total equity and liabilities	6,655	2,861	1,350

The following information is relevant to the preparation of the consolidated financial statements:

(1) On 1 December 20X1, Joey acquired 30% of the ordinary shares of Margy for a cash consideration of $600 million when the fair value of Margy's identifiable net assets was $1,840 million. Joey has equity accounted for Margy up to 30 November 20X3. Joey's share of Margy's undistributed profit amounted to $90 million and its share of a revaluation gain amounted to $10 million for the period 1 December 20X1 to 30 November 20X3. On 1 December 20X3, Joey acquired a further 40% of the ordinary shares of Margy for a cash consideration of $975 million and gained control of the company. The cash consideration paid has been added to the equity accounted balance for Margy at 1 December 20X3 to give the carrying amount at 30 November 20X4.

At 1 December 20X3, the fair value of Margy's identifiable net assets was $2,250 million. At 1 December 20X3, the fair value of the equity interest in Margy held by Joey before the business combination was $705 million and the fair value of the non-controlling interest of 30% was assessed as $620 million. The retained earnings and other components of equity of Margy at 1 December 20X3 were $900 million and $70 million respectively. It is group policy to measure the non-controlling interest at fair value.

(2) At the time of the business combination with Margy on 1 December 20X3, Joey included in the fair value of Margy's identifiable net assets, an unrecognised contingent liability with a fair value of $6 million in respect of a warranty claim in progress against Margy, considered to have been measured reliably. In March 20X4, there was a

revision of the estimate of the liability to $5 million. The amount has met the criteria to be recognised as a provision in current liabilities in the financial statements of Margy and the revision of the estimate is deemed to be a measurement period adjustment.

(3) Buildings with a carrying amount of $200 million had been included in the fair value of Margy's identifiable net assets at 1 December 20X3. The buildings have a remaining useful life of 20 years at 1 December 20X3 and are depreciated on the straight-line basis. However, Joey had commissioned an independent valuation of the buildings of Margy which was not complete at 1 December 20X3 and therefore not considered in the fair value of the identifiable net assets at the acquisition date. The valuations were received on 1 April 20X4 and resulted in a decrease of $40 million in the fair value of property, plant and equipment at the date of acquisition. This decrease does not affect the fair value of the non-controlling interest at acquisition and has not been entered into the financial statements of Margy. The excess of the fair value of the net assets over their carrying amount, at 1 December 20X3, is due to an increase in the value of non-depreciable land and the contingent liability.

(4) On 1 December 20X3, Joey acquired 80% of the equity interests of Hulty, a private entity, in exchange for cash of $700 million, gaining control of Hulty from that date. Because the former owners of Hulty needed to dispose of the investment quickly, they did not have sufficient time to market the investment to many potential buyers. The fair value of the identifiable net assets was $960 million. Joey determined that the fair value of the 20% non-controlling interest in Hulty at that date was $250 million. Joey reviewed the procedures used to identify and measure the assets acquired and liabilities assumed and to measure the fair value of both the non-controlling interest and the consideration transferred. After that review, Hulty determined that the procedures and resulting measures were appropriate. The retained earnings and other components of equity of Hulty at 1 December 20X3 were $300 million and $40 million respectively. The excess in fair value is due to an unrecognised franchise right, which Joey had granted to Hulty on 1 December 20X2 for five years. At the time of the acquisition, the franchise right could be sold for its market price. It is group policy to measure the non-controlling interest at fair value.

All goodwill arising on acquisitions has been impairment tested with no impairment being required.

(5) From 30 November 20X3, Joey carried a property in its statement of financial position at its revalued amount of $14 million in accordance with IAS 16 *Property, Plant and Equipment*. Depreciation is charged at $300,000 per year on the straight-line basis. In March 20X4, the management decided to sell the property and it was advertised for sale. On 31 March 20X4, the sale was considered to be highly probable and the criteria for IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* were met. At that date, the property's fair value was $15.4 million and its value in use was $15.8 million. Costs to sell the property were estimated at $300,000. On 30 November 20X4, the property was sold for $15.6 million. The transactions regarding the property are deemed to be material and no entries have been made in the financial statements regarding this property since 30 November 20X3 as the cash receipts from the sale were not received until December 20X4.

Required

(a) (i) Explain, showing relevant calculations and with reference to IFRS 3 *Business Combinations*, how the goodwill balance in Joey's consolidated financial statements at 30 November 20X4 should be calculated. **(10 marks)**

(ii) Explain how the transaction described in Note 5 above should be accounted for in Joey's consolidated financial statements at 30 November 20X4. **(6 marks)**

(iii) Prepare, showing required calculations, an extract from Joey's consolidated statement of financial position showing the group retained earnings at 30 November 20X4. **(4 marks)**

(b) The Joey Group wishes to expand its operations. As part of this expansion, it has granted to the employees of Margy and Hulty, some of whom are considered key management personnel, options over its own shares as at 7 December 20X4. The options vest immediately. Joey is not proposing to make a charge to the subsidiaries for these options.

Joey does not know how to account for this transaction.

Required

Explain to Joey how the above transaction should be dealt with in the subsidiaries' financial statements and Joey's consolidated financial statements, and advise on any disclosures that may be required to ensure external stakeholders are aware of the transaction. **(5 marks)**

(Total = 25 marks)

2 Jogger

Jogger is a public limited company operating in the retail sector. It has recently appointed a new managing director who is reviewing the draft financial statements for the year ended 30 September 20X9.

(a) The managing director is intrigued by why the annual report and financial statements contains 'more than just numbers' and questions you as to why it is beneficial to Jogger to produce so much information.

Required

Explain the factors which provide encouragement to companies to disclose social and environmental information in their financial statements, briefly discussing whether the content of such disclosure should be at the company's discretion. **(8 marks)**

(b) The managing director is keen to present the financial results from his first period of leadership in the best possible light. He considers EBITDA to be the most important measure of performance and has suggested that the reported profits under IFRS and alternative measures such as EDITBA can be managed to ensure Jogger reports strong performance. He wants to know whether the finance team have taken advantage of all of the options available to enable this and has reminded the financial controller that he will receive a substantial bonus if earnings targets are met.

Required

Discuss, from the perspective of investors and potential investors, the benefits and shortfalls of reporting EBITDA and comment on the nature of, and incentives for, 'management of earnings' and whether such a process can be deemed to be ethically acceptable. **(15 marks)**

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

(Total = 25 marks)

Section B – BOTH questions are compulsory and MUST be attempted

3 Klancet

You are the newly appointed finance director of Klancet, a public limited company operating in the pharmaceuticals sector. The company has not had a finance director for several months and the managing director is seeking advice on several financial reporting issues.

(a) Klancet produces and sells its range of drugs through three separate divisions. In addition, it has two laboratories which carry out research and development activities.

In the first laboratory, the research and development activity is funded internally and centrally for each of the three divisions. It does not carry out research and development activities for other entities. Each of the three divisions is given a budget allocation which it uses to purchase research and development activities from the laboratory. The laboratory is directly accountable to the division heads for this expenditure.

The second laboratory performs contract investigation activities for other laboratories and pharmaceutical companies. This laboratory earns 75% of its revenues from external customers and these external revenues represent 18% of the organisation's total revenues.

The performance of the second laboratory's activities and of the three separate divisions is regularly reviewed by the chief operating decision maker (CODM). In addition to the heads of divisions, there is a head of the second laboratory. The head of the second laboratory is directly accountable to the CODM and they discuss the operating activities, allocation of resources and financial results of the laboratory.

Required

(i) Advise the managing director, with reference to IFRS 8 *Operating Segments*, whether the research and development laboratories should be reported as two separate segments. **(6 marks)**

The managing director does not think IFRS 8 provides information that is useful to investors. He feels it just adds more pages to financial statements that are already very lengthy.

Required

(ii) Critique the managing directors' view that IFRS 8 does not provide useful information to investors. **(5 marks)**

(iii) Advise Klancet as to the potential impact, if any, of the IASB's Discussion Paper *Disclosure Initiative – Principles of Disclosure* on the requirements of IFRS 8. **(4 marks)**

(b) Klancet is collaborating with Retto, a third party, to develop two existing drugs owned by Klancet.

Project 1

In the case of the first drug, Retto is simply developing the drug for Klancet without taking any risks during the development phase and will have no further involvement if regulatory approval is given. Regulatory approval has been refused for this drug in the past. Klancet will retain ownership of patent rights attached to the drug. Retto is not involved in the marketing and production of the drug. Klancet has agreed to make two non-refundable payments to Retto of $4 million on the signing of the agreement and $6 million on successful completion of the development.

Project 2

Klancet and Retto have entered into a second collaboration agreement in which Klancet will pay Retto for developing and manufacturing an existing drug. The existing drug already has

regulatory approval. The new drug being developed by Retto for Klancet will not differ substantially from the existing drug. Klancet will have exclusive marketing rights to the drug if the regulatory authorities approve it. Historically, in this jurisdiction, new drugs receive approval if they do not differ substantially from an existing approved drug.

The contract terms require Klancet to pay an upfront payment on signing of the contract, a payment on securing final regulatory approval, and a unit payment of $10 per unit, which equals the estimated cost plus a profit margin, once commercial production begins. The cost-plus profit margin is consistent with Klancet's other recently negotiated supply arrangements for similar drugs.

Required

Prepare notes for a presentation to the managing director of Klancet as to how to account for the above contracts with Retto in accordance with IFRS and with reference to the *Conceptual Framework* and the related Exposure Draft. **(8 marks)**

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

(Total = 25 marks)

4 Jayach

(a) IFRS 13 *Fair Value Measurement* defines fair value, establishes a framework for measuring fair value and requires significant disclosures relating to fair value measurement.

IFRS 13 gives guidance regarding fair value measurements in existing standards, although it does not apply to transactions dealt with by certain specific standards. Fair value measurements are categorised into a three-level hierarchy, based on the type of inputs to the valuation techniques used.

Required

Discuss the main principles of fair value measurement as set out in IFRS 13. **(8 marks)**

(b) Jayach, a public limited company, is reviewing the fair valuation of certain assets and liabilities in light of the introduction of IFRS 13.

It carries an asset that is traded in different markets and is uncertain as to which valuation to use. The asset has to be valued at fair value under International Financial Reporting Standards. Jayach currently only buys and sells the asset in the Australasian market. The data relating to the asset are set out below.

Year to 30 November 20X2	*Asian market*	*European market*	*Australasian market*
Volume of market – units	4 million	2 million	1 million
Price	$19	$16	$22
Costs of entering the market	$2	$2	$3
Transaction costs	$1	$2	$2

Additionally, Jayach had acquired an entity on 30 November 20X2 and is required to fair value a decommissioning liability. The entity has to decommission a mine at the end of its useful life, which is in three years' time. Jayach has determined that it will use a valuation technique to measure the fair value of the liability. If Jayach were allowed to transfer the liability to another market participant, then the following data would be used.

Input	*Amount*
Labour and material cost	$2 million
Overhead	30% of labour and material cost
Third party mark-up – industry average	20%
Annual inflation rate	5%
Risk adjustment – uncertainty relating to cash flows	6%
Risk-free rate of government bonds	4%
Entity's non-performance risk	2%

Jayach needs advice on how to fair value the liability.

Required

Discuss, with relevant computations, how Jayach should fair value the above asset and liability under IFRS 13. **(11 marks)**

(c) The directors of Jayach have received an email from its majority shareholder.

To: Directors of Jayach

From: A Shareholder

Re: Measurement

I have recently seen an article in the financial press discussing the 'mixed measurement approach' that is used by lots of companies. I hope this isn't the case at Jayach because 'mixed' seems to imply 'inconsistent'? Surely it would be better to measure everything in the same way? I would appreciate it if you could you provide further information at the next annual general meeting on measurement bases, covering what approach is taken at Jayach and why, and the potential effect on investors trying to analyse the financial statements.

Required

Prepare notes for the directors of Jayach which discuss the issues raised in the shareholder's email. **(6 marks)**

(Total = 25 marks)