Answers

1 (a) (i) IFRS® 13 *Fair Value Measurement* permits a range of valuation methods to estimate fair value including market based, income estimates and a cost-based approach. However, the characteristics of each asset should be considered when determining the most appropriate methodology.

Fair value is defined as the price which would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is therefore not supposed to be entity specific but rather to be market focused. The estimate consequently should consider what the market would be prepared to pay for the asset.

The market would consider all alternative uses for the assessment of the price which they would be willing to pay. Fair value should therefore be measured by consideration of the highest and best use of the asset. There is a presumption that the current use would be the highest and best use.

The highest and best use of the asset would appear to be as residential property and not the current industrial use. The intentions of Colyson Co are not relevant as fair value is not entity specific. The alternative use would need to be based upon fair and reasonable assumptions. In particular, it would be necessary to ensure that planning permission to demolish the factory and convert into residential properties would be likely. Since several nearby sites have been given such permission, this would appear to be the case.

The fair value of the factory site should be valued as if converted into residential use. Since this cannot be determined on a stand-alone basis, the combined value of the land and buildings is calculated. The $1 million demolition and planning costs should be deducted from the market value of $24 million. The fair value of the land and buildings should be $23 million. The fair value of the identifiable net assets at acquisition are $88 million ($65m + $23m).

Depreciated replacement cost should only be considered as a possible method for estimating the fair value of the asset when other more suitable methods are not available. This may be the case when the asset is highly specialised and market data is therefore limited or unavailable. This is not the case with the factory site. In any case, the rise in value of land and properties particularly for residential use would mean that to use depreciated replacement cost would undervalue the asset. The exit value for the asset, whether it was based on the principal or most advantageous market, would need to be the same as the entry price. Depreciation may not also be an accurate reflection of all forms of obsolescence including physical deterioration. The estimate would need to be adjusted for such factors even where industrial use remained the best use of the asset.

(ii) Goodwill should be calculated as follows:

	Fair value method $ millions	Proportional method $ millions
Consideration	90	90
Non-controlling interest (NCI) at acquisition	22	17·6
Net assets at acquisition	(88)	(88)
Goodwill	24	19·6

NCI at acquisition under proportional method is $17·6m (20% x $88m).

The fair value of the net assets at acquisition is $88m as per part a(i) ($65m + $23m).

Tutorial note: *Goodwill under the proportional method could also be calculated as:*

Consideration	*$90m*
Less FV of net assets acquired (80% x $88m)	*($70·4)m*
Goodwill on acquisition	*$19·6m*

(b) An impairment arises where the carrying amount of the net assets exceeds the recoverable amount. Where there is a clear indication of impairment, this asset should be reduced to the recoverable amount.

Where the cash flows cannot be independently determined for individual assets, they should be assessed as a cash generating unit. That is the smallest group of assets which independently generate cash flows. Impairments of cash generating units are allocated first to goodwill and then pro rata on the other assets. It should be noted that no asset should be reduced below its recoverable amount.

Fair value method

The overall impairment of Colyson Co is $30 million ($106m + goodwill $24m – $100m). The damaged building should be impaired by $4 million with a corresponding charge to profit or loss. Since $4 million has already been allocated to the land and buildings, $26 million remains. The goodwill should therefore be written off and expensed in the consolidated statement of profit or loss.

Of the remaining $2 million, $1·25 million will be allocated to the plant and machinery (15/(15 + 9) x 2m) and $0·75 million will be allocated to the remaining intangibles (9/(9 + 15) x 2m). As no assets have been previously revalued, all the impairments are charged to profit or loss. $24 million (80% x $30m) will be attributable to the owners of Luploid Co and $6 million to the NCI in the consolidated statement of comprehensive income.

The allocation of the impairment is summarised in this table:

	Original value $m	Impairment $m	Revised CV $m
Land and buildings	60	4	56
Plant and machinery	15	1·25	13·75
Intangibles other than goodwill	9	0·75	8·25
Goodwill	24	24	0
Current assets (at recoverable amount)	22	0	22
Total	130	30	100

Proportionate method

The basic principles and rule for impairment is the same as the fair value method and so $4 million will again first be written off against the land and buildings. The problems arise when performing the impairment review as a cash generating unit. When NCI is measured using the proportional share of net assets, no goodwill is attributable to the NCI since goodwill is not included within the individual net assets of the subsidiary. This means that the goodwill needs to be grossed up when an impairment review is performed so that it is comparable with the recoverable amount. Under the fair value method, the NCI fully represents any premium the other shareholders would be prepared to pay for the net assets and so goodwill does not need to be grossed up.

The goodwill of $19·6 million is grossed up by 100/80 to a value of $24·5 million. This extra $4·9 million is known as notional goodwill. The overall impairment is now $30·5 million ($106m + $24·5m – $100m) of which $4 million has already been allocated. Since the remaining impairment of $26·5 million exceeds the value of goodwill, the goodwill is written down to zero. However, as only $19·6 million goodwill is recognised within the consolidated accounts, the impairment attributable to the notional goodwill is not recognised. Only $19·6 million is deducted in full from the owners of Luploid Co's share of profits since there is no goodwill attributable to the non-controlling interest. The remaining $2 million impairment is allocated between plant and machinery and intangibles (other than goodwill). NCI will be allocated 20% of $6m ($4m + $2m), i.e. $1·2 million. Consolidated retained earnings will be charged with 80% of $6m (i.e. $4·8m) plus $19·6 million goodwill impairment (i.e. $24·4m in total). The allocation of the impairment is summarised in this table:

Tutorial note: *Notional goodwill and impairment of notional goodwill does not impact on the consolidated financial statements.*

	Original carrying amount $m	Impairment $m	Revised carrying amount $m
Land and buildings	60	4	56
Plant and machinery	15	1·25	13·75
Intangibles other than goodwill	9	0·75	8·25
Goodwill	19·6	19·6	0
(Notional goodwill)	4·9	4·9	0
Current assets (at recoverable amount)	22		22
Total	130·5	30·5	100

(c) (i) IFRS 3 *Business Combinations* requires all consideration to be measured at fair value on acquisition of a subsidiary. This will include the deferred shares. Since Luploid Co is obliged to replace the share-based scheme of Hammond Co on acquisition, the replacement scheme should also be included as consideration. There is, however, a post combination service period which means that the portion of the replacement scheme attributable to pre-combination service is the market value of the acquiree award multiplied by the ratio of the portion of the vesting period completed to the greater of the total vesting period or the original vesting period of the acquiree award.

The vesting period of the acquiree award had vested and was three years. As there is a two-year post combination vesting period, the total vesting period is five years. Therefore the amount attributable to the pre-combination period (and therefore added to the cost of the investment) should be $15 million x 3/5 = $9 million.

Deferred shares should be measured at the fair value at the acquisition date with subsequent changes in fair value ignored. Luploid Co will issue 2·4 million (60% x 10m x 2/5) shares as consideration. The market price at the date of acquisition was $30, so the fair value is $72 million. The total consideration should be valued as $81 million (72 + 9).

(ii) The fair value of the replacement scheme at the grant date is $18 million (100 x 10,000 x 90% x $20). Since $9 million has been allocated to the cost of the investment, the remaining $9 million should be treated as part of the post combination remuneration package for the employees and measured in accordance with IFRS 2 *Share-based Payment*. The fair value at the grant date of the share-based scheme should be expensed to profit or loss over the two-year vesting period. Subsequent changes to the fair value of the shares are ignored.

Luploid Co will need to consider the impact of market and non-market based vesting conditions. The condition relating to the share price of Luploid Co is a market based vesting condition. These are adjusted for in the calculation of the fair value at the grant date of the option. An expense is therefore recorded in the consolidated profit or loss of Luploid Co irrespective of whether the market based vesting condition is met or not. A corresponding credit should be included within equity.

2 Cash advance from Budster Co

Stent Co's finance director also controls Budster Co, the company which has paid a cash advance to Stent Co. International Accounting Standard (IAS®) 24 *Related Party Disclosures* requires an entity's financial statements to contain disclosures necessary to draw attention to the possibility that its financial statements may have been affected by the existence of related parties and by transactions and outstanding balances with such parties. Included in the definition of a related party is a person identified as holding significant influence over the entity, or who is a member of the key management personnel of the entity. The finance director, a key management personnel of Stent Co, is a related party. In this case, Stent Co must disclose the nature of the related party relationship as well as information about all transactions and outstanding balances between Stent Co and Budster Co (owned and controlled by the finance director), necessary for users to understand the potential effect of the relationship on the financial statements.

The advance from Budster Co meets the *Conceptual Framework* definition of a liability: Stent Co has a present obligation (legally enforceable as a consequence of a binding contract), the settlement of which involves Stent Co giving up resources embodying economic benefits in order to satisfy the claim. IAS 1 *Presentation of Financial Statements* states that an entity shall not offset assets and liabilities, unless required or permitted by an International Financial Reporting Standard (IFRS®). The finance director wants to include the receipt as a credit balance in trade receivables, netting off any amounts owed by Budster Co from trading, with what appears to be a short-term loan. This would result in a misclassification of a current liability under current assets. Offsetting a financial asset and a financial liability is permitted according to IAS 32 *Financial Instruments: Presentation* when, and only when, an entity has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. No such agreement is evident in this case, so Stent Co should report separately both assets and liabilities.

Except when it reflects the substance of the transaction or other event, offsetting detracts from the ability of users both to understand the transactions, other events and conditions which have occurred and to assess the entity's future cash flows. Stent Co would be showing a lower current asset figure and concealing the liability, which if disclosed as a current liability could be included in the debt element of the gearing calculation. Gearing would therefore increase.

Convertible redeemable preference shares

IAS 32 defines an equity instrument as any contract which evidences a residual interest in the assets of an entity after deducting all of its liabilities. An equity instrument has no contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities under potentially unfavourable conditions. If settled by the issuer's own equity instruments, an equity instrument has no contractual obligation to deliver a variable number, or is settled only by exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

Preference shares which are required to be converted into a fixed number of ordinary shares on a fixed date should be classified as equity (this is known as the 'fixed for fixed' requirement to which the finance director refers). However, a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer either to deliver cash or another financial asset to the holder, or to exchange financial assets or financial liabilities with the holder, under conditions which are potentially unfavourable to the issuer. In this case, Stent Co has issued convertible redeemable preference shares – which makes little commercial sense from the company's perspective, as they offer the holder the benefit of conversion into ordinary shares if share prices rise, and the security of redemption (at the choice of the holder) if share prices fall.

IAS 32 notes that the substance of a financial instrument, rather than its legal form, governs its classification in the entity's statement of financial position. A preference share which provides for mandatory redemption for a fixed or determinable amount at a fixed or determinable future date or gives the holder the right to require the issuer to redeem the instrument at a particular date for a fixed or determinable amount is a financial liability.

Because the preference shares offer the holder the choice of conversion into ordinary shares as well as redemption in two years' time, the terms of the financial instrument should be evaluated to determine whether it contains both a liability and an equity component. Such components are classified separately as compound financial instruments, recognising separately the components of a financial instrument which creates both a financial liability of the entity (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity).

In accordance with IFRS 9 *Financial Instruments*, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. Stent Co would measure the fair value of the consideration in respect of the liability component based on the fair value of a similar liability without any associated equity conversion option. The equity component is assigned the residual amount.

Gearing would decrease if the draft financial statements had included the preference shares within equity: the correction would increase non-current debt (the present value of the future obligations) and decrease equity.

Deferred tax asset

In accordance with IAS 12 *Income Taxes*, a deferred tax asset shall be recognised for the carry-forward of unused tax losses to the extent that it is probable that future taxable profit will be available against which the unused tax losses can be utilised.

However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses only to the extent that it has convincing evidence that sufficient taxable profit will be available against which the unused tax losses can be utilised. In such circumstances, the amount of the deferred tax asset and the nature of the evidence supporting its recognition must be disclosed. The directors of Stent Co should consider whether it is probable that Stent Co will have taxable profits before the unused tax losses or unused tax credits expire, whether the unused tax losses result from identifiable causes which are unlikely to recur; and whether tax planning opportunities are available to the entity which will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised. To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset should not be recognised.

The removal of a deferred tax asset would reduce net assets, and equity. Gearing would therefore increase.

Ethical aspects

The ACCA Rulebook contains the bye-laws, regulations and *Code of Ethics and Conduct*, which every ACCA member should follow. The accountant may feel pressured by the finance director's comments on job security given the accountant has only been in her position for a few months. The accountant should comply with the fundamental ethical principles set out in the ACCA Rulebook: to act with integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. The accountant should be mindful of any threats to these fundamental ethical principles. In doing so, the accountant should consider the relevant facts, the ethical issues involved, the fundamental principles which are threatened, whether internal procedures exist which mitigate the threats, and what alternative courses of action could be taken.

In this case, all fundamental ethical principles with the exception of confidentiality appear under threat. The finance director appears to be allowing bias and undue influence from the pressures imposed by debt covenant gearing and overdraft limits into the choice of accounting treatment, rather than following accounting standards. The company is in a precarious position, reporting losses in the year. The finance director should act professionally, in accordance with applicable technical and professional standards, comply with relevant laws and regulations, and avoid any action which discredits the profession.

The finance director faces an advocacy threat by promoting accounting treatments which compromise objectivity. The accountant faces an intimidation threat given the comments from the finance director, who presumably has an influence over career prospects. Assuming the accountant wishes to keep her job, this intimidation threat is also linked to one of self-interest. Before acting, the accountant should speak with the finance director, try to confirm the facts, and discuss the treatment with the finance director and explain the risks of non-compliance: the safeguards of accounting regulations and the sanctions imposed on those professional accountants who do not comply may resolve the issue. A record of conversations and actions should be kept. Stent Co may also have internal procedures which mitigate the threats. It may be that the finance director is not technically up to date, in which case a safeguard would be to undergo continuing professional development. If the finance director refuses to comply with accounting standards, then it would be appropriate to discuss the matter with other directors or an audit committee (if applicable), to seek a solution, then seek professional advice from ACCA, and consider legal advice if necessary. A final consideration for the accountant, if matters cannot be satisfactorily resolved, would be resignation.

3 (a) (i) Revenue recognition: Clamusic Co shares

IFRS 15 *Revenue from Contracts with Customers* requires that non-cash consideration received should be measured at the fair value of the consideration received. If fair value cannot be reasonably estimated, the consideration should be measured by reference to the stand-alone selling price of the good or service promised in the contract. The fair value of non-cash consideration may vary. If the non-cash consideration varies for reasons other than the form of the consideration, entities will apply the guidance in IFRS 15 related to constraining variable consideration. However, if fair value varies only due to the form, the variable constraint guidance in IFRS 15 would not apply. In this case, the fair value varies due to the form of the consideration which is equity shares and therefore the variable constraint guidance in IFRS 15 does not apply.

The fair valuation of shares in an unlisted start-up company is problematic. However, IFRS 13 *Fair Value Measurement* gives advice on how to measure unlisted shares. It sets out three approaches: (i) market approach, such as the transaction price paid for identical or similar instruments of an investee; (ii) the income approach, for example, using discounted cash flow; and (iii) the adjusted net asset approach.

In this case, the market approach has been used and the range of fair values is significant based upon the professional valuation report. The range of fair values for a 7% holding of shares would be $280,000 to $350,000 (7% of $4–$5 million) at the date of the contract and $420,000 to $490,000 (7% of $6–$7 million) at the year end. As the fair valuation is based upon a similar listed company and is based upon a controlling interest, a discount on the valuation of the shares should be applied to reflect the lack of liquidity and inability to participate in Digiwire Co's policy decisions. Thus an estimated value of the shares can be made which takes into account the above facts. This could be the mid-point of $315,000 (($280,000 + $350,000)/2) at the date of the contract and $455,000 (($420,000 + $490,000)/2) at the year end. Digiwire Co would therefore recognise revenue of $315,000 for the receipt of shares from Clamusic Co, as the fair value of non-cash consideration is measured at the contract inception date of 1 January 20X6. This revenue would not be recognised at a point in time but would be recognised over the period of the licence which is three years.

Clamusic Co share valuation at 31 December 20X6

The shares will be recognised at $455,000 (($420,000 + $490,000)/2) at 31 December 20X6. All equity investments in scope of IFRS 9 *Financial Instruments* should be measured at fair value in the statement of financial position, with value changes being recognised in profit or loss. If an equity investment is not held for trading, an entity can make an irrevocable election at initial recognition to measure it at fair value through other comprehensive income (FVTOCI) with only dividend income recognised in profit or loss.

If Digiwire Co elects to present the remeasurements through other comprehensive income (OCI), gains are never recycled through profit or loss. This means that, if the investment in Clamusic Co is successful, when the investment is sold, there will be no profit or loss effect since all gains will already have been recognised in OCI. Thus at the year end, a gain of $140,000 ($455,000 – $315,000) will be recorded in profit or loss or OCI dependent upon any election being made.

(ii) Revenue: royalties

As Digiwire Co retains an active role in the updating and maintenance of a sold licence to ensure its continuing value to the client, revenue would be recognised over the expected length of the contract or related client relationship. An entity must be expected to undertake activities which significantly affect the licence to conclude that revenue is recognised over time. However, reliable measurement of future royalties is not available (see below). Thus, in this case, the revenue would be recognised over the three-year licence based upon the licence agreement. At the year end, however, revenue from royalties can be calculated based upon the sales for the period and it would be $50,000 (5% of $1 million).

The *Conceptual Framework* support

The International Accounting Standards Board has changed the definitions of income and expenses in the revised *Conceptual Framework* (the *Framework*) to align with the revised definitions of an asset and a liability. The definition of income encompasses increases in assets or decreases in liabilities which result in increases in equity, other than those relating to contributions from holders of equity claims.

The revised *Framework* also states that an item which meets the definition of an element should only be recognised if it provides users of financial statements with information which is useful. The *Framework* defines useful information as: (a) relevant information; and (b) a faithful representation. Relevance may not always be achieved if there is uncertainty over existence or the probability of an inflow of economic benefits is low. Faithful representation will be affected by measurement uncertainty.

Thus, in this case, the royalties cannot be measured with any certainty in the future and should not be recognised until certain as only then would it meet the relevance and faithful representation thresholds per the *Framework*. The definitions in the *Framework* relating to income and recognition are therefore consistent with the approach taken by Digiwire Co.

(b) (i) It seems that Digiwire Co and TechGame jointly control FourDee Co and it appears as though the arrangement is a joint venture (IFRS 11 *Joint Arrangements*) as the parties have joint control of the arrangement and have rights to the net assets of the arrangement. Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. This is the case with FourDee Co.

A joint venturer recognises its interest in a joint venture as an investment and accounts for that investment using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures* unless the entity is exempted.

(ii) Digiwire Co has exchanged non-monetary assets for its investment in FourDee Co, and thus needs to de-recognise the assets it is contributing to FourDee Co. The carrying amount of $6 million of the property is derecognised but the intellectual property of Digiwire Co has been generated internally and does not have a carrying amount. The cryptocurrency is recorded as an asset in the financial statements of Digiwire Co at $3 million but will be valued at $4 million, its fair value in the financial statements of FourDee Co.

Accordingly, when a joint venturer contributes a non-monetary asset to a joint venture in exchange for an equity interest in the joint venture, the joint venturer recognises a portion of the gain or loss on disposal which is attributable to the other parties to the joint venture (except when the contribution lacks commercial substance). Essentially, Digiwire Co is required by IAS 28 to limit the profit on disposal of its non-monetary assets to 50%. Effectively, Digiwire has only disposed of 50% of the asset contributed to the joint venture. Thus the carrying amount of the joint venture in Digwire's financial statements at 31 December 20X6 will be $11·5 million (($6 + $3 carrying amounts derecognised for property and cryptocurrency) + ((4 – 3)/2) + ((10 – 6)/2)). A gain of $2·5 million will be recorded in profit or loss.

(iii) If the cryptocurrency meets the definition of a financial asset, it is possible to measure it at fair value. However, cryptocurrency is not cash or cash equivalents as its value is exposed to significant changes in market value and there is no contractual right to receive either cash or cash equivalents. Therefore, cryptocurrency fails the definition of a financial asset.

If the cryptocurrency is to be recognised as an intangible asset, then the default position would be to measure it at cost. However, there may be an argument to say that there is an active market for the cryptocurrency in which case, it would be possible for it to be measured at fair value. In this case, movements in that fair value would be recognised through other comprehensive income and the gain would not be recycled through profit or loss when the cryptocurrency is realised.

The best way to account for a cryptocurrency would be fair value as that is the value at which the entity will realise their investment or transact in exchange for goods and services. Accounting for cryptocurrency at fair value with movements

reflected in profit or loss would provide the most useful information to investors but existing accounting requirements do not appear to permit this.

(c) (i) Before the amendment, IAS 19 *Employee Benefits* did not require entities to revise the assumptions for the calculation of current service cost and net interest during the accounting period, even if an entity remeasured the net defined benefit liability or asset in the event of a plan amendment, curtailment or settlement. The calculations were based on the actuarial assumptions as at the start of the financial year.

However, the International Accounting Standards Board felt that it was inappropriate to ignore any updated assumptions when determining current service cost and net interest for the period.

Therefore, an amendment to IAS 19 states that when a plan amendment, curtailment or settlement occurs during the annual reporting period, an entity must:

– Determine current service cost for the remainder of the period after the plan amendment, curtailment or settlement using the actuarial assumptions used to remeasure the net defined benefit liability/asset reflecting the benefits offered under the plan and the plan assets after that event.

– Determine net interest for the remainder of the period after the plan amendment, curtailment or settlement using: (i) the net defined benefit liability/asset reflecting the benefits offered under the plan and the plan assets after that event; and (ii) the discount rate used to remeasure that net defined benefit liability/asset.

(ii) If Digiwire Co had not applied the revised IAS 19, then the current service cost would have been $108 million (12 months x $9 million). On the application of the revised standard, the current service cost would be $96 million ((8 months x $9 million) + (4 months x $6 million)).

Thus there will be a reduction in the current service cost of $12 million.

Similarly, the net interest component before the amendment would have been $900,000 (3% x $30 million).

After the amendment it would be $1,020,000 (($900,000 x 8/12) + (3·5% x $36m x 4/12)).

Therefore, there will be a change in the net interest element of $120,000 ($1,020,000 – $900,000).

The net effect will be to change the re-measurement component by $11,880,000.

4 (a) Where an IFRS standard allows an entity an accounting choice, then the financial statements will be influenced and affected by that choice. Management's intent and motivation will influence accounting information. The accounting policy chosen can be driven by self-interest, by a wish to maximise the interests of shareholders, or by a wish to provide information. Where there is flexibility when applying the IFRS standard, the financial statements can become less comparable. Entities may use the financial choices to increase earnings, and manipulate accounting figures in order to influence contractual outcomes which depend on the accounting figures reported.

Accounting choices exist to provide companies which operate under different business models with the option of utilising an accounting method which best represents their operations. Any accounting choice in IFRS standards should still result in the financial statements being faithfully represented. A faithful representation means that to the maximum extent possible, the financial statements are complete, neutral and free from error. A faithful representation is affected by the level of measurement uncertainty in the financial statements.

Comparability is one of the four qualitative characteristics which enhances the usefulness of information. Thus accounting information would be more useful if it can be compared with similar information from other entities, or from the same entity.

However, it is extremely difficult for entities to have 'comparable' financial information. Comparability is crucial to improve financial reporting quality but it can be argued that comparability is made more difficult by the fact that the Board allows entities to choose between alternative measurement bases. Environmental, economic, political, cultural, operational differences could be solved with the existence of accounting choices in the standards, but these choices could be at the cost of comparability, especially if there are internal or external factors influencing the reliable disclosure of an item. A faithful representation might lead to comparability, because it should reflect the characteristics of the asset or liability.

(b) (i) The return on equity (ROE) ratio measures the rate of return which the owners of issued shares of a company receive on their shareholdings in terms of profitability. ROE signifies how good the company is in generating profit on the investment it receives from its shareholders. This metric is especially important from an investor's perspective, as it can be used to judge how efficiently the firm will be able to use shareholder's investment to generate additional revenues.

The net profit margin (net profit/sales) tells how much profit a company makes on every dollar of sales. Asset turnover (sales/assets) ratio measures the value of a company's sales or revenues generated relative to the carrying amount of its assets. The asset turnover ratio can often be used as an indicator of the efficiency with which a company is deploying its assets in generating revenue. The equity ratio indicates the relative proportion that equity is used to finance a company's assets. The equity ratio is a good indicator of the level of leverage used by a company by measuring the proportion of the total assets which are financed by shareholders, as opposed to creditors.

	20X5	20X6
Net profit margin	15%	17·3%
Asset turnover	0·8	1·05
Equity ratio	1·43	2·1
Return on equity	17%	38%

(ii) Setting up of special purpose entity (SPE)

IFRS 10 *Consolidated Financial Statements* states that an investor controls a SPE when it is exposed, or has rights, to variable returns from its involvement with the SPE and has the ability to affect those returns through its power over the SPE. This revised definition of control focuses on the need to have both power and variable returns before control is present. Power is the current ability to direct the activities which significantly influence returns. Guidance Co obtains the rewards from the assets transferred and is exposed to the risks. By transferring their assets to a SPE, the asset turnover ratio will be significantly larger. However, the SPE should be consolidated by Guidance Co in its group financial statements and the property included in assets and the charge eliminated from revaluation reserves in its single entity financial statements. The latter will increase shareholder equity.

Miscellaneous transactions

A major concern about using ROE is when a company buys back its shares, it decreases the equity on the statement of financial position and in the case of Guidance Co, its cash and consequently its total assets. As a result, the performance metrics – asset turnover and ROE – will be affected. The ROE figure could produce a misleading indicator as to how well a company is being managed. As the equity portion of ROE shrinks, the ROE metric gets larger. The ROE calculation can become meaningless if a company regularly buys back its shares and thus as a result there may be better metrics for investors to use such as the P/E ratio.

Guidance Co has raised loan capital of $20 million during the period and this amount will not be included in the ROE calculations because ROE is based on assets as opposed to net assets. One company may have a higher ROE than another company simply because it finances the business through loan capital rather than raising equity capital. It can be argued that ROE is not a meaningful measure of performance, as it takes no account of the amount of debt involved in creating profits.

Therefore, return on capital employed may be a better current measure for Guidance Co.

Guidance Co has included the profit from the purchase of an associate in the current year's figures. If the share of the results of the associate were excluded, this would allow Guidance Co's profitability to result exclusively from Guidance Co's asset base. It could be argued that the full value of the company's reported profit including the associate could distort the analysis of Guidance Co's performance as compared to the last financial year.

There is no need to adjust for the original $15 million investment in the associate because one asset is merely being replaced by another but the total assets remain the same.

Adjusted amounts

		SPE property $m	Shares cancelled $m	Associate $m	Total $m
Net profit before tax	38			(4)	34
Sales	220				220
Assets	210	50	30		290
Equity	100	50	30	(4)	176

Adjusted calculations

	20X5	20X6 (adjusted)	20X6 (unadjusted)
Net profit margin	15%	15·5%	17·3%
Asset turnover	0·8	0·76	1·05
Equity ratio	1·43	1·65	2·1
ROE	17%	19·3%	38%

It can be seen that if the impact of the transactions in the period were eliminated, then there has been a significant reduction in ROE and its component parts. The buy back of shares and the purchase of the associate were legitimate transactions but they were eliminated in order to determine comparative metrics. The raising of the loan capital was also legitimate but was not adjusted for because ROE is based on assets, not net assets. The transfer of assets to a SPE was contrary to IFRS 10 and would have been reversed in any event. Although financial metrics are intended to enable comparisons between companies, the relative performance of any particular company can be affected by transactions both acceptable and unacceptable under accounting standards.

				Marks	*Marks*
1	**(a)**	**(i)**	– application of the following discussion to the scenario:		
			how FV should be determined	5	
			why depreciation replacement cost is unsuitable	2	7
		(ii)	– calculation marks for:		
			correct FV of net assets	1	
			correct NCI figures	2	3
	(b)		– discussion of what constitutes an impairment and CGUs	2	
			– correct calculation of impairment losses for both methods	2	
			– notional goodwill	1	
			– impairment allocation	3	
			– discussion of how and why methods differ	3	11
	(c)	**(i)**	– calculation FV of deferred shares	1	
			– calculation of FV of options	1	
			– discussion of the above calculations and application to the scenario	2	4
		(ii)	– calculation share expense	1	
			– application of the following discussion to the scenario:		
			why expense required	2	
			vesting conditions	2	5
					30
2	**(a)**		– application of the following discussion to the scenario:		
			cash advance from related party	4	
			preference shares: convertible	4	
			deferred tax asset	3	11
	(b)		– discussion of ethical principles	2	
			– application of ethical principles to the scenario, and recommended action	5	7
			Professional marks		2
					20

				Marks	Marks
3	**(a)**	**(i)**	– application of the following discussion to the scenario:		
			IFRS 15 non-cash consideration and IFRS 13 alternatives to value the shares (including share value calculation at year end)	3	
			IFRS 9 remeasurement gains (including calculation)	2	
		(ii)	– application of the following discussion to the scenario:		
			revenue recognised over time	2	
			revised *Conceptual Framework* (2018)	2	9
	(b)	**(i)**	– discussion and application of the IFRS 11 requirements to the scenario	2	
		(ii)	– discussion of the derecognition of non-monetary assets and application to the scenario	2	
			– calculation of carrying amount of the joint venture	1	
		(iii)	– discussion of the potential ways in which the cryptocurrency could be accounted for at fair value	4	9
	(c)	**(i)**	– discussion of the reasons behind the amendments to IAS 19		3
		(ii)	– calculation of current service cost net interest, remeasurement component	3	
			– discussion of impact	1	4
					25
4	**(a)**		– discussion of the issues relating to accounting choice	3	
			– discussion of whether faithful representation and comparability are affected	3	6
	(b)	**(i)**	– discussion of the meaning of the return on equity (ROE) and its component parts	3	
			– calculation of ROE for the years ended 31 December 20X5 and 20X6	2	5
		(ii)	– application of the following discussion to the scenario:		
			transfer of property to SPE	2	
			buy back of shares	2	
			raising loan capital	2	
			purchase of associate	2	
			calculation of the impact on ROE and its component parts	4	12
			Professional marks		2
					25

Note: In each question, some marks are allocated for RELEVANT knowledge. Marks will not be awarded for the reproduction of irrelevant knowledge or irrelevant parts of IFRS Standards. Full marks cannot be gained unless relevant knowledge has been applied. Candidates may also discuss issues which do not appear in the suggested solution. Providing that the arguments made are logical and the conclusions derived are substantiated, then marks will be awarded accordingly.