MARK PLAN AND EXAMINER'S COMMENTARY

The marking plan set out below was that used to mark this question. Markers were encouraged to use discretion and to award partial marks where a point was either not explained fully or made by implication. More marks were available than could be awarded for each requirement. This allowed credit to be given for a variety of valid points which were made by candidates.

Question 1

Total Marks: 25

General comments

Part 1.1 of this question tested the preparation of a statement of profit or loss, a statement of financial position and a statement of changes in equity from a trial balance. Adjustments included an operating lease, a provision for an onerous lease, a bonus issue, an issue of irredeemable preference shares, an over-provision for income tax in the previous year, and a prior period error. Part 1.2 required an explanation of the enhancing qualitative characteristics.

Ballabriggs Ltd

1.1 (a) Statement of profit or loss for the year ended 31 December 2016

	£
Revenue	1,012,400
Cost of sales (W1)	(799,532)
Gross profit	212,868
Administrative expenses (W1)	(36,500)
Other operating costs (W1)	(152,187)
Profit from operations	24,181
Finance cost	(560)
Profit before tax	23,621
Income tax expense (5,600 – 4,250)	(1,350)
Profit for the year	22,271

(b) Statement of financial position as at 31 December 2016

	£	£
Assets		
Non-current assets		
Property, plant and equipment (1,212,920 – 305,600 – 90,732 (W1))		816,588
Current assets		
Inventories	118,600	
Trade and other receivables (208,850 – 22,500)	186,350	
		304,950
Total assets		1,121,538
Equity and liabilities		
Equity		
Ordinary share capital (iii)		600,000
5% irredeemable preference share capital (iii)		200,000
Retained earnings (iii)		155,981
		955,981
Non-current liabilities		
Provisions (52,487 – 18,692) (W2)	33,795	
Other payables (W1)	6,000	
		39,795
Current liabilities		
Trade and other payables	95,240	
Borrowings	6,230	
Provisions (W2)	18,692	
Taxation	5,600	
		125,762
Total equity and liabilities		1,121,538

(c) Statement of changes in equity for the year ended 31 December 2016

	Ordinary share capital	5% irredeemable preference share capital	Share premium	Retained earnings
	£	£	£	£
At 1 January 2016 (600,000 – 100,000) (W3)	500,000	-	60,000	231,210
Prior period adjustment	-	-	-	(22,500)
Restated	500,000	-	60,000	208,710
Issue of preference share capital	-	200,000	-	-
Bonus issue	100,000		(60,000)	(40,000)
Final dividends on irredeemable preference shares (W1)	-	-	-	(5,000)
Interim dividends on ordinary shares (W3)				(30,000)
Total comprehensive income for the year	-	-	-	22,271
At 31 December 2016	600,000	200,000	-	155,981

Workings

(1) Allocation of expenses

	Cost of sales	Admin expenses	Other operating costs
	£	£	£
Per draft	741,800	211,500	98,700
Opening inventories	85,600		
Closing inventories	(118,600)		
Release & reversal of provision		(175,000)	
Depreciation charge ((1,212,920 –305,600) x 10%)	90,732		
Onerous lease (W2)			52,487
Operating lease (1,000 x 6)			6,000
Preference dividend			(5,000)
	799,532	36,500	152,187

(2) Onerous lease

	Rent £	Discount factor	£
31 December 2017	20,000	1/1.07	18,692
31 December 2018	20,000	$1/1.07^2$	17,469
31 December 2019	20,000	$1/1.07^3$	16,326
			52,487

(3) Retained earnings at 1 January 2016

	£
Per TB	101,210
Add back: Bonus issue	100,000
Ordinary dividend (600,000 x 5p)	30,000
	231,210

This part was generally well answered by the majority of candidates. However, a number of candidates wasted time writing at length as to how they would deal with the issues in the question, with some even providing journal entries. This approach of “describing” rather than “doing” was something seen in the early days of the paper, but which had been seen less and less in recent sittings – until now.

The statement of profit or loss was typically well presented and complete. Common errors included incorrectly adjusting the revenue figure for the prior year adjustment and adding the preference dividend to the finance cost. The calculation of the tax charge for the year was often incorrect, with the overprovision from the prior year either being ignored or incorrectly added to the current year estimate.

In the statement of financial position the majority of candidates were able to correctly calculate the carrying amount for property, plant and equipment. Most also correctly adjusted the trade receivables figure for the double counting of the customer invoice even where they had also adjusted both revenue and retained earnings for this. The most common error was to include the overdraft as cash and cash equivalents, failing to spot that it was a credit balance in the trial balance and therefore should have been included in current liabilities.

The accrual for rent was often omitted, although where it was accrued for it was generally calculated correctly, although a minority of candidates incorrectly calculated the number of months. The onerous lease provision proved difficult for a number of candidates, and it was not unusual for this figure to be completely omitted. The most common mistake made was to not discount the provision, although candidates who did try to discount the figure often applied the three years discount factor to the total amount. Whether the figure was discounted or not a significant number of candidates did try to split the provision between current and non-current liabilities.

Those students who made errors on the tax expense usually also gave an incorrect figure for the liability on the statement of financial position, often including the over provision. A small minority of candidates treated the preference shares as a liability, ignoring the clues in the question indicating that the substance of the transaction was that of an equity instrument.

Many candidates were not sure how to deal with the release and reversal of the provision with a number deducting part of the provision within administrative expenses and leaving the rest of the provision on the statement of financial position. Others correctly included no provision on the statement of financial position but then did not always include the full credit of £175,000 in administrative expenses.

The statement of changes in equity, where one was attempted, was the least well completed of the three statements. Several candidates excluded the irredeemable preference shares, and made errors in the opening balances of the ordinary share capital and retained earnings. Many candidates did not restate the opening balances for the prior period adjustment, or if they did this only did it for the retained earnings column. A worrying minority of candidates were unable to deal correctly with the bonus issue made during the year – it was not unusual to see a credit to retained earnings. A significant number of candidates wasted time producing (most typically) a working for the closing retained earnings figure, which in some cases duplicated the retained earnings column and in others arrived at a different closing balance.

Total possible marks	23½
Maximum full marks	22

1.2 Enhancing qualitative characteristics

Comparability ensures that users can identify and understand similarities in and differences among items. Information about a reporting entity is more useful if it can be compared from one reporting period to the next and with similar information from other entities.

Consistency is related to comparability but is not itself an enhancing qualitative characteristic. Comparability is the goal – consistency helps to achieve that goal. Consistency refers to the same methods being used for the same items ie consistent accounting policies. The disclosure of accounting policies therefore allows users to make a valid comparison.

Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent – it adds credibility to the financial statements. It means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation.

Timeliness means that information is available to users in time to be capable of influencing their decisions. Generally the older information is the less useful it is.

Understandability means classifying, characterising and presenting information clearly and concisely. However, information about complex phenomena should not be excluded just because it is difficult to understand, as to omit such information could mean that the financial statements are incomplete and potentially misleading.

Financial statements are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even such well-informed and diligent users may need to seek the aid of an advisor in order to understand complex phenomena.

This part of the question was generally well answered, with good use of the open book text to explain the enhancing qualitative characteristics. Marks were also awarded for relevant examples. Those who scored badly tended to be vague in their descriptions of the characteristics, presumably not realising that they could have used the open book text. Weaker candidates also sometimes gave examples which were not relevant to the characteristic under which they were given. There was also a minority of candidates who clearly didn't understand the characteristics, referring to, for example, timing as ensuring financial statements were filed with Companies House on time.

Total possible marks	11
Maximum full marks	5

Question 2

Total Marks: 25

General comments

This question covered a number of issues relating to property, plant and equipment. Part 2.1 required an explanation of how the issues in one of the matters should have been dealt with in the financial statements. This included the impairment of a piece of land (which subsequently needed to be reflected in the property, plant and equipment table in Part 2.2), but also a related party transaction, which needed to be disclosed. Part 2.2 required candidates to redraft a property, plant and equipment table, which contained a number of errors, including the impairment. The other errors concerned a finance lease, a change of depreciation method and a disposal. Part 2.3 required extracts from the statement of cash flows and supporting note. Part 2.4 required an explanation of the ethical issues arising from the scenario and the action to be taken.

Papillon Ltd

2.1 Explanation of matter (2)

Related party transaction

Bobbyjo LLP is wholly-owned by a close family member of a member of Papillon Ltd's key management personnel, so Bobbyjo LLP is a related party of Papillon Ltd. This transaction with Bobbyjo LLP is therefore a related party transaction.

Disclosure is required of all related party transactions, even if the transactions took place on an arm's length basis or are immaterial in size. Although it seems likely from the facts that the valuation was not independent, however there is nothing to indicate that £1,000 is not an arm's length price for a report such as this. Even if the transactions did take place on an arm's length basis that fact may only be disclosed if such terms can be substantiated.

Disclosure should be made of:

- The nature of the relationship (an entity owned by the wife of a director of Papillon Ltd)
- The amount of the transaction (£1,000)
- The amount of any balance outstanding at the year end (£1,000)

There is no requirement to identify related parties by name.

Impairment of asset

The discovery that the land was contaminated in January 2017 is an adjusting event, providing evidence that at the year end the property was only worth £325,500. Because the carrying amount of the land is greater than its recoverable amount the land had therefore suffered an impairment of £24,500 (350,000 – 325,500) as at 31 December 2016. Because the land had previously been revalued, the impairment loss should first be charged to the revaluation surplus in respect of that asset, with the remainder being charged to profit or loss. £17,400 (350,000 – 332,600) should therefore be charged to the revaluation surplus and £7,100 ((24,500 – 17,400) or (332,600 – 325,500)) to profit or loss. Anthony has credited £100,000 to profit or loss which he should not have done so profits will now decrease by £107,100 (100,000 + 7,100).

Answers to this part were generally disappointing. It was rare to see an answer that addressed both the impairment and the related party transaction in any depth.

The majority of candidates wasted time explaining how revaluations work in general and focused on the revaluation in 2014 which had actually been accounted for correctly. Generally, candidates did identify that an impairment had taken place during the current year, although it was less common to see an explanation of the correct treatment. Only a minority of candidates specifically identified that this was an adjusting event, even if they then went on to treat it this way. A significant majority of those candidates who did correctly calculate the impairment did manage to allocate it firstly against the balance on revaluation surplus with the remainder charged to profit or loss. However, a good number did not realise that the upwards revaluation in the year should first be reversed.

The other issue was the identification of the related party transaction. It was disappointing that far fewer candidates correctly identified this issue, although some then discussed this issue (including the related disclosure requirements) in the ethics part of the question, thereby missing the marks available here. Those candidates who did identify the related party transaction then went on to provide generally reasonable responses.

Total possible marks	13
Maximum full marks	8

2.2 Revised property, plant and equipment table

	Land and buildings £	Plant and equipment £
Cost/valuation		
At 1 January 2016	1,250,600	526,800
Additions (75,600 – (16,000 + 16,000) = 43,600 + 59,571)	–	103,171
Disposals		(15,000)
Impairment (350,000 – 325,500)	(24,500)	–
At 31 December 2016	1,226,100	614,971
Accumulated depreciation		
At 1 January 2016	345,600	316,000
Disposals ((15,000 /10yrs) x 7yrs)	–	(10,500)
Charge for the year (W)	25,100	64,024
At 31 December 2016	370,700	369.524
Carrying amount		
At 31 December 2016	855,400	245,447
At 31 December 2015	905,000	210,800

Working

Depreciation charge – plant and equipment

	£
Leased asset (59,571 ÷ 3)	19,857
Other addition (43,600 x 20% x 4/12)	2,907
Other plant and equipment ((526,800 – 15,000) – (316,000 – 10,500)) x 20%)	41,260
	64,024

Most candidates made a reasonable attempt at redrafting the disclosure note, obtaining the easier marks for presentation and the opening balances. Virtually all candidates recognised that there was no need to adjust the depreciation charge for land and buildings and simply entered the figure given in the question straight into their answer. The figure for additions to plant and equipment was less well done with many candidates not removing the lease payments from the original figure and others failing to capitalise the leased asset or capitalising it at the wrong amount. The disposal of the machine was on occasion shown as a net figure (within either cost or accumulated depreciation) or omitted entirely. Even where candidates arrived at the correct impairment charge in Part 2.1 few thought to include it here.

Candidates found the calculation of the depreciation charge for plant and equipment challenging with common errors being failing to use the shorter lease term for depreciation of the leased asset, not pro-rating the depreciation on the addition in the year, and not adjusting the depreciation charge on the remaining assets for the disposal of the machine. However, most candidates did correctly deal with the change of depreciation method by applying it to the opening carrying amount. A common problem was that there was no “audit trail” for the final figure entered onto the disclosure note. Nonetheless, a good number of candidates achieved full marks on this part of the question.

Total possible marks	10
Maximum full marks	8

2.3 Statement of cash flows for the year ended 31 December 2016 (extracts)

	£
Cash flows from investing activities	
Purchase of property, plant and equipment	(43,600)
Proceeds from sale of property, plant and equipment	800
Cash flows from financing activities	
Payment of finance lease liabilities (32,000 – 2,179 (W))	(29,821)

Reconciliation of profit before tax to cash generated from operations for the year ended 31 December 2016 (extracts)

	£
Depreciation charges (25,100 + 64,024)	89,124
Impairment (2.1)	7,100
Loss on sale of property, plant and equipment (15,000 – 10,500 – 800)	3,700

Working

Interest on finance lease = 59,571 – 16,000 = 43,571 x 5% = 2,179

Answers to this part of the question were very mixed. Many candidates correctly included the disposal proceeds in investing activities, and an outflow under financing activities for the finance lease payments, but few went beyond this. Although the finance cost figure for the lease was usually calculated it was rarely used to reduce the lease payments to arrive at the correct cash flow. The finance costs of the lease were often incorrectly calculated as candidates did not adjust for the initial instalment of £16,000 before applying the interest rate.

In the reconciliation, generally candidates included adjustments for depreciation (but often with no audit trail to show that this was the correct own figure from Part 2.2) and often for the finance costs of the lease. Few included the impairment from Parts 2.1 and 2.2. Although the loss on disposal was usually calculated, it was often then not included here. Some candidates also included adjustments for the accrual and finance cost, which was not expected as there was insufficient information given in the question to calculate these figures in full. However, credit was given when marking.

Total possible marks	6
Maximum full marks	4

2.4 Ethical issues

Anthony's financial reporting knowledge seems lacking, given that he failed to deal properly with the impairment, and failed to account for the finance lease and the disposal. As an ICAEW Chartered Accountant Anthony is obliged to comply with the ICAEW code of ethics, including the principle of professional competence and due care, and should keep his knowledge up to date.

Alternatively, it is possible that the incorrect accounting treatments were followed deliberately by Anthony. All of the "errors" made by Anthony have the effect of overstating the profit for the year. The fact that Anthony is entitled to a bonus based on profit for the year gives a clear self-interest threat for Anthony. Anthony should have ignored this self-interest threat and prepared the figures accurately, in accordance with the principles of objectivity, independence and professional behaviour.

The fact that Anthony has revalued upwards an asset which is clearly impaired, and has taken that increase to profit for the year also points to a possible lack of integrity. More so, if Anthony engineered the valuation via his wife's company and his wife's company failed to discover (or disclose) the contamination. Furthermore, the other directors are unaware of Anthony's relationship to this company.

There is a possible intimidation threat to yourself from Anthony and his offer to recommend you for a permanent job if you ignore the "errors" creates a self-interest threat for yourself. The very fact that Anthony has made this offer also adds to the theory that Anthony lacks integrity.

You should mitigate the self-interest threat by taking the following action: - Discuss each of the errors found with Anthony, explaining the correct IFRS accounting treatment to him. - If Anthony appears genuinely to be out of date tactfully suggest that he goes on an update course. - Ensure the disclosure note is corrected. - If needed, seek support from the managing director. - Document all discussions. - If you find yourself in a difficult situation, eg, caught between Anthony and the MD, or subject to any sort of intimidation threat, then consult the ICAEW helpline.	
This part was generally very well-answered with a good number of candidates achieving full marks. Candidates are clearly well-schooled in spotting the “clues” in the question, identifying the relevant threats and appropriate action. Almost all candidates spotted the self-interest threat for Anthony (the profit-related bonus) and for themselves (the offer of a permanent job) and the possible intimidation threat from Anthony. Those candidates who simply stated that there was a related party transaction and went on to explain what should be disclosed gained no marks here. However, where a candidate indicated that the related party transaction might show a lack of integrity on Anthony’s part marks were awarded.	
Total possible marks Maximum full marks	12 5

Question 3

Total Marks: 26

General comments

Part 3.1 required the preparation of a consolidated statement of financial position. The question featured one subsidiary, and one associate, both of which were acquired during the year. Consolidation adjustments included intra-group balances, unrealised profit on trading and a fair value adjustment on acquisition (of a depreciating asset). The associate featured an asset at acquisition with a fair value above its carrying amount, with a need to subsequently adjust for additional depreciation. Part 3.2 required a calculation of distributable profits with accompanying explanation. Part 3.3 required a description of the differences between IFRS and UK GAAP in respect of the calculation and subsequent treatment of goodwill arising on consolidation.

3.1 Consolidated statement of financial position as at 31 December 2016

	£	£
Assets		
Non-current assets		
Property, plant and equipment (1,162,800 + 321,390 + 60,000 – 5,000 (W1))		1,539,190
Intangibles (W2)		226,000
Investments (774,500 – 650,000 – 120,500 + 6,000 (W4))		10,000
Investment in associate (W6)		130,790
		1,905,980
Current assets		
Inventories (523,600 + 398,500 – 1,600 (W5)	920,500	
Trade and other receivables (401,860 + 203,650 – 16,000)	589,510	
Cash and cash equivalents (52,600 + 1,100 + 5,000)	58,700	
		1,568,710
Total assets		3,474,690
Equity and liabilities		
Equity attributable to owners of Corbiere plc		
Ordinary share capital		600,000
Share premium account		100,000
Retained earnings (W4)		1,862,602
		2,562,602
Non-controlling interest (W3)		168,388
Total equity		2,730,990
Current liabilities		
Trade and other payables (385,200 + 148,500 – 11,000)	522,700	
Deferred consideration (140,000 (W2) + 3,500) (W4)	143,500	
Taxation (53,900 + 23,600)	77,500	
		743,700
Total equity and liabilities		3,474,690

Workings

(1) Net assets – Seagram Ltd

	Year end	Acquisition	Post acq
	£	£	£
Share capital	200,000	200,000	
Share premium	50,000	50,000	
Retained earnings			
Per Q	502,540	404,000	
Less: PURP (W5)	(1,600)	–	
Fair value adjustment	60,000	60,000	
Depreciation thereon ((60,000 ÷ 6) x 6/12)	(5,000)	–	
	805,940	714,000	91,940

(2) Goodwill – Seagram Ltd

	£
Consideration transferred (650,000 + (147,000/1.05))	790,000
Non-controlling interest at acquisition – FV	150,000
Net assets at acquisition (W1)	(714,000)
	226,000

(3) Non-controlling interest – Seagram Ltd

	£
NCI at acquisition date – FV	150,000
Share of post-acquisition reserves (91,940 (W1) x 20%)	18,388
	168,388

(4) Retained earnings

	£
Corbiere plc	1,776,260
Deferred consideration – unwinding (140,000 x 5% x 6/12)	(3,500)
Seagram Ltd (91,940 (W1) x 80%)	73,552
Minnehoma Ltd (W6)	10,290
Minnehoma Ltd's dividend (20,000 x 30%)	6,000
	1,862,602

(5) Inventory PURP

	%	£
SP	125	16,000
Cost	(100)	(12,800)
GP	25	3,200
X ½		1,600

(6) Investments in associate – Minnehoma Ltd

		£
Cost		120,500
Add: Share of post acquisition profits ((56,800 – 20,000) x 30%)	11,040	
Less: FV depreciation ((50,000 ÷ 20) x 30%)	(750)	
		10,290
		130,790

This part of the question was well answered with a significant number of candidates preparing completely correct net assets, goodwill, non-controlling interest and provision for unrealised profit workings. Nearly all candidates also produced a complete and reasonably well-presented consolidated statement of financial position and most attempted to adjust for the intra-group balances.

However, far fewer candidates correctly calculated the figures for the investment in the associate and for consolidated retained earnings. With regard to the investment in the associate, most candidates successfully calculated the basic share of post-acquisition profits but then made one or more of the following errors:

- failing to deduct the dividend paid from the associate's profit for the year
- including the additional depreciation charge arising from the fair value adjustment but failing to multiply that by the 30% holding
- incorrectly including the fair value adjustment itself (or 30% of it) in this working.

It was clear that many candidates do not understand the relationship between the investment in associate and consolidated retained earnings workings as it was quite rare to see the same post acquisition figures in both of these workings. The two most common errors in the consolidated retained earnings calculation were:

- failing to add the dividend received from the associate
- not adjusting for the unwinding of the discount relating to the deferred consideration or adjusting for a full year rather than for six months.

The other most common error was to fail to adjust the investments figure for the cost of the subsidiary and associate and the dividend incorrectly credited to this account. Even where there was an adjustment for this dividend it was often deducted rather than added and/or was for the full dividend rather than for the 30% share actually received.

Other common errors included:

- failing to multiply the provision for unrealised profit by half to reflect the amount still held at the year end and/or calculating it using a gross profit margin rather than a mark up
- deducting the wrong amounts from receivables and payables for the intra-group trading
- omitting the subsidiary's share premium account from the net assets working
- omitting the deferred consideration from current liabilities (or including the wrong amount).

Once again, a number of candidates lost marks by failing to show an adequate audit trail – it is not sufficient to show, for example, "W1 x 80%"; candidates must show the figure and the percentage used.

Total possible marks	21
Maximum full marks	19

3.2 Distributable profits

For entities within a group, distributable profits must be made for each individual entity, rather than the consolidated group. Therefore, Corbiere plc's distributable profits are those profits distributable by the parent company only.

The basic rule is that distributable profits are measured as accumulated realised profits less accumulated realised losses, this is usually retained earnings of the individual company.

In the case of listed companies, here it is not clear whether Corbiere plc is listed or not, the amount of distributable profits is further reduced by any excess of unrealised losses over unrealised profits/cannot reduce net assets below total of called-up share capital and undistributable reserves. No such information is available in this question to determine this reduction.

Corbiere plc's distributable profits are therefore calculated as:

- The 30% share of the associate only affects the consolidated retained earnings, but Corbiere plc's own financial statements would include the dividend from Minnehoma Ltd of £6,000. This should have been recognised in Corbiere plc's own statement of profit or loss. However this was incorrectly deducted from investments, so retained earnings need to increase by £6,000.

- The finance cost arising on the deferred consideration will be payable by Corbiere plc and therefore reduces retained earnings by £3,500.

Corbiere plc's distributable reserves are therefore £1,776,260 + 6,000 – 3,500 = £1,778,760.

Answers to this part were disappointing. Although most candidates did refer to accumulated realised profits less accumulated realised profits few went further than this. Often explanations were confused and some very strange calculations were made. Many candidates lost really easy marks for not commenting that the figures should be based on individual rather than group financial statements or that the starting point was normally retained earnings. A worrying number of candidates took the consolidated retained earnings figure as the starting point for their calculation. Of those who did start with the parent's retained earnings, very few arrived at the correct figure.

Total possible marks	7
Maximum full marks	3

3.3 IFRS v UK GAAP differences re calculation and subsequent treatment of goodwill arising on consolidation

UK GAAP	IFRS
- Requires goodwill to be amortised over its useful life, with rebuttable presumption that this should not exceed ten years	- Goodwill is subject to annual impairment review
- Impairment losses re goodwill may be reversed	- Not allowed
- Acquisition related costs added to cost of acquisition	- Acquisition related costs are expensed
- Negative goodwill presented on the balance sheet/in non-current assets directly under positive goodwill, as a negative asset	- Negative goodwill recognised in profit or loss/retained earnings
- Non-controlling interest must be measured using the proportionate method	- Can use the proportionate method or the fair value method
- Recognises implicit goodwill on the acquisition of an associate or joint venture and requires it to be amortised	- No separate goodwill recognised
- No specific requirement to reassess contingent consideration each year. However, where the amount was not probable or could not be reliably measured the amount should be subsequently measured and the amount related back to the acquisition date, hence impacting the goodwill figure.	- Requires the measurement of contingent consideration to be reassessed (at fair value) each year with differences taken to profit or loss

Answers to this part were generally good with a number of candidates achieving full marks. Most included the points re amortisation versus impairment, the two methods available for calculating goodwill and the treatment of negative goodwill. Fewer referred to the issues relating to the reversal of impairments, acquisition costs and goodwill relating to associates and joint ventures. Hardly any referred to the contingent consideration differences. One common error was to refer to the UK GAAP rebuttable presumption of the maximum useful life for goodwill as five, as opposed to ten, years. Others expressed this as an absolute maximum, rather than a presumption which could be challenged.

Many candidates also wasted time by calculating goodwill using the proportionate method; the requirement clearly stated “describe” so no calculations were required. If calculations under UK GAAP are required that will be specified in the requirement.

Total possible marks	9
Maximum full marks	4

Question 4

Total Marks: 27

General comments

This question required candidates to explain the financial reporting treatment of three accounting matters, given in the scenario. The matters covered borrowing costs, convertible bonds and the calculation of goodwill arising on the acquisition of a subsidiary.

Bindaree Ltd

4 IFRS accounting treatment

(1) Borrowing costs

Per IAS 23, Borrowing Costs, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should form part of the cost of that asset/be capitalised. A qualifying asset is one which takes a substantial period of time to get ready for use. Since the factory has now been under construction for over a year/is still in progress it would seem to meet that criteria.

The borrowing costs to be capitalised are those that would have been avoided if expenditure on the qualifying asset had not been incurred. Since these funds were borrowed specifically for the construction then this will be the actual borrowing costs incurred, less any investment income received on the excess funds.

Capitalisation of borrowing costs should commence when all three of the following conditions are met:

- Expenditure is incurred on the asset (met as the land was acquired on 1 February 2016).
- Borrowing costs are incurred (met as the loan was taken out on 1 January 2016).
- Activities are undertaken necessary to prepare the asset for its intended use (only met at 1 July 2016 when work started on the construction).

Capitalisation of borrowing costs should therefore commence on 1 July 2016.

The interest receivable and payable before commencement of capitalisation of borrowing costs should have been recognised in profit or loss. Interest payable was £10,000 (500,000 x 4% x 6/12) and interest receivable was:

	£
1 Jan 2016 – 31 Jan 2016 (500,000 x 3% x 1/12)	1,250
1 Feb 2016 – 30 June 2016 ((500,000 – 200,000) x 3% x 5/12)	3,750
	5,000

The following net borrowing costs should be capitalised:

	£
Borrowing costs incurred (1 July 2016 – 31 Dec 2016)	10,000
Less: Investment income	
1 July 2016 – 31 Dec 2016 ((500,000 – 200,000 – 100,000) x 3% x 6/12)	(3,000)
	7,000

The costs to date of constructing the factory of £407,000 (200,000 + 100,000 + 100,000 + 7,000) should be included as an asset in the course of construction/within property, plant and equipment. No depreciation should be charged on this asset in the year ended 31 December 2016 as it is not yet ready for use/construction is still ongoing.

(2) Convertible bonds

The convertible bonds are a compound/hybrid financial instrument per IAS 32, Financial Instruments: Presentation. Such instruments have both an equity and a debt component which should be presented separately at the time of issue. This is often called "split accounting" and reflects the substance of the instrument.

The amount received on issue should be allocated between the separate components as follows:

- The liability component should be measured at the present value of the capital and interest payments assuming the bond is redeemed. The discount rate used should be the effective rate for an instrument with the same terms and conditions without the conversion option.
- The equity component will measured at the remainder of the net proceeds.

	Cash flow	**Discount factor @ 5%**	**Present value**
	£	**£**	**£**
1 January 2017	8,000	1/1.05	7,619
1 January 2018	8,000	$1/1.05^2$	7,256
1 January 2019 (redemption)	208,000	$1/1.05^3$	179,678
Liability component			194,553
Equity component (bal fig)			5,447
Total			200,000

The liability is initially calculated at £194,553 and the equity component as the residual of £5,447.

Once recognised the equity element remains unchanged. However, the liability component should be shown at amortised cost at each year end.

1 January 2016	**Interest @ 5%**	**Payment @4%**	**31 December 2016**
£	**£**	**£**	**£**
194,553	9,728	(8,000)	196,281

The annual interest of £9,728 should be included in finance costs. The £196,281 should be included in non-current liabilities.

(3) Goodwill arising on the acquisition of a subsidiary

IFRS 3, Business Combinations requires that the acquiree's identifiable assets and liabilities assumed should be recognised at fair value at the date of the acquisition. Goodwill is then calculated as the consideration transferred plus the value of any non-controlling interest less the net assets acquired/share of net assets.

An acquirer may only recognise an acquiree's liabilities if they exist at the acquisition date. There is no indication that the reorganisation plan has been announced. Therefore no account can be taken of future losses or the cost of the reorganisation.

However, the contingent liability should be recognised for the purposes of calculating goodwill at its fair value because, per IFRS 3 its fair value can be measured reliably. The contingent liability should be carried at the higher of the amount which would be recognised under IAS 37 the amount recognised on acquisition, which will be nil (until it becomes a liability) and £200,000 respectively.

IFRS 3 states that an intangible asset should be recognised separately from goodwill if it meets the definition of an intangible asset per IAS 38, Intangible Assets, and its fair value can be measured reliably. Per IAS 38, an intangible asset must be separable or arise from contractual or legal rights. The customer list is separable as it could be sold separately from the rest of the business and it has been measured reliably, by virtue of the independent valuation. Therefore the net assets at acquisition should include the customer list.

Goodwill should therefore be calculated as:

		£	£
Fair value of consideration			252,000
Non-controlling interest at acquisition (529,800 x 30%)			158,940
Less:	Fair value of net assets acquired		
	Net assets per question	679,800	
	Less: Contingent liability	(200,000)	
	Add: Customer list	50,000	
			(529,800)
Gain on bargain purchase			(118,860)

Per IFRS 3, in order to check that this has not arisen due to errors in the measurement of the fair value of the consideration or of the net assets acquired the identification and measurement of those elements should be reassessed. The gain on bargain purchase should be recognised in consolidated profit or loss for the year ended 31 December 2016 and therefore increases retained earnings at that date.

Matter (1): Answers to this part were varied but most candidates obtained the basic marks for discussing when such costs should be capitalised, the relevant criteria and the fact that interest income should be netted off the interest expense to be capitalised. However, a common error was to select the incorrect date for when capitalisation should start. Most candidates correctly listed out the three conditions which needed to be met before capitalisation should start. However, even when candidates stated that this should start on the latest of the three dates, and included 1 July in their dates, as being the date on which the activities necessary to prepare the asset for use started, many candidates then selected 1 February (the date on which the land was acquired) as being the appropriate date. Others thought that the activities necessary to prepare the asset for use started when the land was purchased on 1 February, as opposed to the when construction started. A number of candidates discussed at length when capitalisation should cease, which was not relevant as the asset was still in the course of construction at the year end.

In general calculations were overly complicated and difficult to follow. Few candidates clearly separated out the interest payable and receivable up until 1 July (and often failed to say that this should be taken to the income statement) and the amounts after that date which should be capitalised. The bulk of candidates wrongly calculated both the interest payable and the interest received which should be capitalised. As the loan was taken out specifically for the factory construction, interest to be capitalised was that on the whole loan, not just on the funds used. Similarly, the loan interest received to be set off against the interest payable was the interest earned from the date capitalisation started. The majority of candidates wrongly set off the interest received for the whole year.

Matter (2): This part was very well answered with nearly all candidates recognising that this was a compound financial instrument and correctly calculating the initial amount of the liability and equity components. Most also went on to write out the amortised cost table for the first year to arrive at the correct finance cost and closing liability. However, many candidates incorrectly split the liability into current and non-current amounts despite the fact that nothing was to be repaid for three years. Weaker candidates produced the relevant calculations with little supporting explanation.

Matter (3): The answers to the final part of the question were disappointing. Many candidates wrote at length about general consolidation issues rather than focusing on the various items in the scenario that should or should not affect the calculation of the net assets at acquisition. Many candidates wrote generally about provisions and intangible assets rather than focusing on how they should be dealt with in the context of an acquisition and this scenario. Many "hedged their bets" on how to deal with the various items, an approach which earned few marks. Surprisingly few candidates said that the future losses of £750,000 could not be provided for at the acquisition date. Those who did say this rarely explained why.

Nearly all candidates did attempt to calculate goodwill (although often failed to also describe this calculation in words) but often their calculation did not include the adjustments they had described. Some also wasted time producing more than one calculation. Even those who did arrive at the correct goodwill figure were often unable to explain why the relevant adjustments to net assets had to be made. Almost all candidates stated the correct treatment of negative goodwill but hardly any suggested that the fair value adjustments should be checked.

Total possible marks	37
Maximum full marks	22