Answers

1 (a) Ashanti Group: Statement of comprehensive income for the year ended 30 April 2010 (see working 1)

	$m
Revenue	1,096
Cost of sales	(851)
Gross profit	245
Other income	57·8
Distribution costs	(64)
Administrative expenses	(96·01)
Investment income	1·67
Finance costs	(31·98)
Share of profit of associate	2·1
Profit before tax	114·58
Income tax expense	(49)
Profit for the year	65·58
Other comprehensive income for the year, net of tax:	
Available-for-sale financial assets (AFS)	29·6
Gains on property revaluation	19·6
Actuarial losses on defined benefit plan	(14)
Share of other comprehensive income of associates	0·9
Other comprehensive income for the year, net of tax	36·1
Total comprehensive income and expense for year	101·68
Profit/loss attributable to: (W8)	
Owners of the parent	51·19
Non-controlling interest (W8)	14·39
	65·58

Total comprehensive income attributable to:

	$m
Owners of the parent	81·20
Non-controlling interest (W8) (14·39 + 6·09)	20·48
	101·68

Working 1

	Ashanti $m	Bochem $m	Ceram $m	Adjustment $m	Total $m
Revenue	810	235	71	(15)	
Revenue from illiquid customer (W5)	(5)				1,096
Inter company profit ($5m x 20%)	(1)				
Cost of sales	(686)	(137)	(42)	15	(851)
Gross profit	118	98	29		245
Gain on sale of Ceram (W3)		3·8			
Other income	31	17	6		57·8
Distribution costs	(30)	(21)	(13)		(64)
Administrative expenses	(55)	(29)	(6)		
Holiday pay accrual (W7)	(0·21)				
Depreciation (W2)		(2)			
Loss on revaluation of PPE (W6)	(1·6)				
Impairment of goodwill (W2)		(2·2)			(96·01)
Accrual of bond interest (W4)	1·67				1·67
Impairment of bond (W4)	(13·98)				
Impairment of trade receivable (W5)	(3)				
Available-for-sale financial asset			3		
Finance costs	(8)	(6)	(4)		(31·98)
Share of profits of associate (W3)		2·1			2·1
Profit before tax	38·88	60·7	15		114·58
Income tax expense	(21)	(23)	(5)		(49)
Profit for the year	17·88	37·7	10		65·58
Other comprehensive income for the year, net of tax:					
Available-for-sale financial assets	20	9			
Loss on bond now recognised	0·6				29·6
Gains on property revaluation	12	6	–		
Revaluation adjustment (W6)	1·6				19·6
Actuarial losses on defined benefit plan	(14)	–	–		(14)
Share of associate available-for-sale financial assets (W3)		0·9			0·9
Other comprehensive income for the year, net of tax	20·2	15·9			36·1
Total comprehensive income and expense for year	38·08	53·6	10		101·68

Working 2 Bochem

	$m	$m
Fair value of consideration for 70% interest	150	
Fair value of non-controlling interest	54	204
Fair value of identifiable net assets acquired		(160)
Goodwill		44
Depreciation of plant		
Fair value of identifiable net assets		160
Book value ($55m + $85m + $10m)		(150)
Plant revaluation		10
Dr Profit or loss ($10 x 1/5)		2
Dr Retained earnings		2
Cr Accumulated depreciation		4
Goodwill impairment		
Up to 30 April 2009, $44m x 15%		$6·6 million
Further impairment up to 30 April 2010, $44 x 5%		$2·2 million
Total impairment		$8·8 million
Sale of equity interest in Bochem		
Fair value of consideration received		34
Amount recognised as non-controlling interest (Net assets per question at year end $210m + Fair value of PPE at acquisition $10m – depreciation of fair value adjustment $4m + goodwill (44 – 8·8)) x 10%		(25·12)
Positive movement in parent equity (Shown as movement in equity not in OCI)		8·88

Working 3 Ceram

	$m	$m
Fair value of consideration for 80% interest	136	
Indirect holding in Ceram – NCI (30% of 136)	(40·8)	
Fair value of non-controlling interest	26	121·2
Fair value of identifiable net assets acquired		(115)
Goodwill		6·2

The fair value of the consideration held in Ceram represents the 80% shareholding purchased by Bochem. The 30% element that belongs to the NCI of Bochem needs to be deducted thereby giving the net balance representing the effective 56% (70% of 80%) shareholding from the group viewpoint. However, goodwill could be calculated from the entity's perspective ($47 million) which would give a significantly different goodwill and gain/loss on disposal figure.

As Bochem has sold a controlling interest in Ceram, a gain or loss on disposal should be calculated. Additionally, the results of Ceram should only be consolidated in the statement of comprehensive income for the six months to 1 November 2009. Thereafter Ceram should be equity accounted.

The gain recognised in profit or loss would be as follows:

	$m
Fair value of consideration	90
Fair value of residual interest to be recognised as an associate	45
Value of NCI	35
	170
Less: net assets and goodwill derecognised	
net assets	(160)
goodwill	(6·2)
Gain on disposal to profit or loss	3·8

The gain above has been calculated from Bochem's viewpoint and therefore a portion of this gain belongs to the NCI of Bochem.

The share of the profits of the associate would be 30% of a half year's profit ($7m) i.e. $2·1 million and 30% of half of the gain on the AFS investments i.e. $0·9million.

Working 4 Bond

	$m
Carrying value at 1 May 2009	20·45
Accrual of half year interest (4%) to 31 October 2009	0·82
	21·27
Accrual of half year interest (4%) to 30 April 2010	0·85
Carrying value at 30 April 2010	22·12
Interest accrual (0·82 + 0·85)	1·67
Fair value of bond at 30 April 2010 ($2·34m discounted at 10% + $8m discounted at 10% for two years)	8·74
Impairment of bond (22·12 – 8·74)	13·38
Reclassification of loss in equity	0·6
Impairment recognised in profit or loss	13·98

Note: the accrual of interest could also be based on the amortised cost at 1 May 2009 as an alternative to the carrying value.

Working 5

Ashanti should not record the revenue of $5 million, as it is not probable that economic benefit relating to the sale will flow to Ashanti. The revenue will be recorded when the customer pays for the goods. The cost of the goods will remain in the financial statements and the allowance for doubtful debts will be reduced to $3 million.

Working 6

At 30 April 2009, a revaluation gain of ($13m – $12m – depreciation $1·2m) $2·2 million would be recorded in equity for the PPE. At 30 April 2010, the carrying value of the PPE would be $13m – depreciation of $1·44m i.e. $11·56m. Thus there will be a revaluation loss of $11·56m – $8m i.e. $3·56m. Of this amount $1·96m ($2·2m less $0·24m transfer for excess depreciation) will be charged against revaluation surplus in reserves and $1·6 million will be charged to profit or loss.

Working 7

An accrual should be made under IAS 19 *Employee Benefits* for the holiday entitlement carried forward to next year.

900 x 3 days x 95% = 2,565 days

Number of working days = 900 x 255 = 229,500

Accrual is 2,565/229,500 x $19m = $0·21m

Working 8

Non-controlling interest (NCI)

NCI in profits for year is (30% of $37·7m + 44% of $7 million) =	$14·39m
NCI in other recognised income is (30% x $15·9m + 44% of $3m) =	$6·09m
	$20·48

(b) The International Accounting Standards Board (IASB) has published amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*. The amendments are an attempt to create a 'level playing field' with US GAAP regarding the ability to reclassify financial assets. The changes to IAS 39 permit an entity to reclassify non-derivative financial assets out of the 'fair value through profit or loss' (FVTPL) and 'available-for-sale' (AFS) categories in limited circumstances. Such reclassifications will create additional disclosures. The amendments will only permit reclassification of certain non-derivative financial assets. Financial liabilities, derivatives and financial assets that are designated as at FVTPL on initial recognition under the 'fair value option' cannot be reclassified. The amendments therefore only permit reclassification of debt and equity financial assets subject to meeting specified criteria. The amendments do not permit reclassification into FVTPL or AFS at initial recognition.

A debt instrument that would have met the definition of loans and receivables, if it had not been required to be classified as held for trading at initial recognition, may be reclassified to loans and receivables if the entity has the intention and ability to hold the asset for the foreseeable future or until maturity. A debt instrument classified as AFS that would have met the definition of loans and receivables may be reclassified to the category if the entity has the same intention and ability as above. Any other debt instrument, or any equity instrument, may be reclassified from FVTPL to AFS, or from FVTPL to Held to Maturity (HTM) (in the case of debt instruments only), if the financial asset is no longer held for the purpose of selling in the near term – but only in 'rare' circumstances. The IASB acknowledged that volatile and illiquid market conditions are a possible example of a 'rare' circumstance.

All reclassifications must be made at the fair value of the financial asset at the date of reclassification. Any previously recognised gains or losses cannot be reversed. The fair value at the date of reclassification becomes the new cost or amortised cost of the financial asset, as applicable.

For reclassifications out of AFS, IAS 39 requires the amounts previously recognised in other comprehensive income (OCI) to be reclassified to profit or loss either through the effective interest rate or at disposal. Amounts deferred in equity may also need to be reclassified to profit or loss if there is impairment.

Allowing reclassification, even in limited circumstances, will allow an entity to manage its reported profit or loss by avoiding future fair value gains or losses on the reclassified assets. The intention of this is to ensure that previously impaired cash flows are reflected in the income statement over the life of the asset rather than as immediate income effectively deferring the loss in the hope that economic conditions will improve. The IASB normally publishes an exposure draft of any proposed amendments to standards to invite comments from interested parties. However, the IASB decided to proceed directly to issuing the amendments without any due process. This exceptional step could lead to management of earnings by some entities as the amendments relax the existing requirements to provide 'short-term relief' for some entities. This relief effectively means that anticipated losses could be avoided by entitles. It could be argued that the amendments are a short-term response to a current crisis, which because of the lack of exposure could lead to longer-term issues.

(c) 'Earnings management' has been defined in various ways. It can be described as the purposeful intervention in the external financial reporting process with the intent of obtaining some private gain. Alternatively it can be the use of judgment in financial reporting and in structuring transactions to alter financial reports to either mislead stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting judgments.

Incentives lie at the heart of earnings management. Managers should make accounting judgments and decisions solely with the intention of fairly reporting operating performance. However, there are often economic incentives for managers to engage in earnings management, because the value of the firm and the wealth of its managers or owners are normally linked to reported earnings. Contractual incentives to manage earnings arise when contracts between a company and other parties rely upon financial statements to determine financial exchanges between them. By managing the results of operations, managers can alter the amount and timing of those exchanges. Contractual situations could stimulate earnings management. These would include debt covenants, management compensation agreements, job security, and trade union negotiations. Market incentives to manage earnings arise when managers perceive a connection between reported earnings and the company's market value. Regulatory incentives to manage earnings arise when reported earnings are thought to influence the actions of regulators or government officials. By managing the results of operations, managers may influence the actions of regulators or government officials, thereby minimising political scrutiny and the effects of regulation.

One way in which directors can manage earnings is by manipulation of accruals with no direct cash flow consequences. Examples of accrual manipulation include under-provisioning for irrecoverable debt expenses, delaying of asset write-offs and opportunistic selection of accounting methods. Accrual manipulation is a convenient form of earnings management because it has no direct cash flow implications and can be done after the year-end when managers are better informed about earnings. However, managers also have incentives to manipulate real activities during the year with the specific objective of meeting certain earnings targets. Real activity manipulation affects both cash flows and earnings.

Where management does not try to manipulate earnings, there is a positive effect on earnings quality. The earnings data is more reliable because management is not influencing or manipulating earnings by changing accounting methods, or deferring expenses or accelerating revenues to bring about desired short-term earnings results. The absence of earnings management does not, however, guarantee high earnings quality. Some information or events that may affect future earnings may not be disclosed in the financial statements. Thus, the concept of earnings management is related to the concept of earnings quality. One major objective of the IASB Framework is to assist investors and creditors in making investing and lending decisions. The Framework refers not only to the reliability of financial statements, but also to the relevance and predictive value of information presented in financial statements.

Entities have a social and ethical responsibility not to mislead stakeholders. Ethics can and should be part of a corporate strategy, but a company's first priority often is its survival and optimising its profits in a sustainable way. Management of earnings may therefore appear to have a degree of legitimacy in this regard but there is an obvious conflict. An ethical position that leads to substantial and long-term disadvantages in the market place will not be acceptable to an entity.

It is reasonable and realistic not to rely exclusively on personal morality. A suitable economic, ethical and legal framework attempts to ensure that the behaviour of directors conforms to moral standards. Stakeholders depend on the moral integrity of the entity's directors. Stakeholders rely upon core values such as trustworthiness, truthfulness, honesty, and independence although these cannot be established exclusively by regulation and professional codes of ethics. Thus there is a moral dilemma for directors in terms of managing earnings for the benefit of the entity, which might directly benefit stakeholders and themselves whilst at the same time possibly misleading the same stakeholders.

2 (a) Deferred taxation

A deferred tax asset should be recognised for deductible temporary differences, unused tax losses and unused tax credits to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised. The recognition of deferred tax assets on losses carried forward does not seem to be in accordance with IAS 12 *Income Taxes*. Cate is not able to provide convincing evidence that sufficient taxable profits will be generated against which the unused tax losses can be offset. According to IAS 12 the existence of unused tax losses is strong evidence that future taxable profit may not be available against which to offset the losses. Therefore when an entity has a history of recent losses, the entity recognises deferred tax assets arising from unused tax losses only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available. As Cate has a history of recent losses and as it does not have sufficient taxable temporary differences, Cate needs to provide convincing other evidence that sufficient taxable profit would be available against which the unused tax losses could be offset. The unused tax losses in question did not result from identifiable causes, which were unlikely to recur (IAS 12) as the losses are due to ordinary business activities. Additionally there are no tax planning opportunities available to Cate that would create taxable profit in the period in which the unused tax losses could be offset (IAS 12).

Thus at 31 May 2010 it is unlikely that the entity would generate taxable profits before the unused tax losses expired. The improved performance in 2010 would not be indicative of future good performance as Cate would have suffered a net loss before tax had it not been for the non-operating gains.

Cate's anticipation of improved future trading could not alone be regarded as meeting the requirement for strong evidence of future profits. When assessing the use of carry-forward tax losses, weight should be given to revenues from existing orders or confirmed contracts rather than those that are merely expected from improved trading. Estimates of future taxable profits can rarely be objectively verified. Thus the recognition of deferred tax assets on losses carried forward is not in accordance with IAS 12 as Cate is not able to provide convincing evidence that sufficient taxable profits would be generated against which the unused tax losses could be offset.

(b) Investment

Cate's position for an investment where the investor has significant influence and its method of calculating fair value can be challenged.

An asset's recoverable amount represents its greatest value to the business in terms of its cash flows that it can generate i.e. the higher of fair value less costs to sell (which is what the asset can be sold for less direct selling expenses) and value in use (the cash flows that are expected to be generated from its continued use including those from its ultimate disposal). The asset's recoverable amount is compared with its carrying value to indicate any impairment. Both net selling price (NSP) and value in use can be difficult to determine. However it is not always necessary to calculate both measures, as if the NSP or value in use is greater than the carrying amount, there is no need to estimate the other amount.

It should be possible in this case to calculate a figure for the recoverable amount. Cate's view that market price cannot reflect the fair value of significant holdings of equity such as an investment in an associate is incorrect as IAS 36 prescribes the method of conducting the impairment test in such circumstances by stating that if there is no binding sale agreement but an

asset is traded in an active market, fair value less costs to sell is the asset's market price less the costs of disposal. Further, the appropriate market price is usually the current bid price.

Additionally the compliance with IAS 28, *Investments in associates* is in doubt in terms of the non-applicability of value in use when considering impairment. IAS 28 explains that in determining the value in use of the investments, an entity estimates:

(i) its share of the present value of the estimated future cash flows expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; or
(ii) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Estimates of future cash flows should be produced. These cash flows are then discounted to present value hence giving value in use.

It seems as though Cate wishes to avoid an impairment charge on the investment.

(c) Disposal group 'held for sale'

IAS 27 Revised *Consolidated and Separate Financial Statements* moved IFRS to the use of the economic entity model. The economic entity approach treats all providers of equity capital as shareholders of the entity, even when they are not shareholders in the parent company. IFRS 5 has been amended such that if there is an intention to dispose of a controlling interest in a subsidiary which meets the definition of 'held for sale', then the net assets are classified as 'held for sale', irrespective of whether the parent was expected to retain an interest after the disposal. A partial disposal of an interest in a subsidiary in which the parent company loses control but retains an interest as an associate or trade investment creates the recognition of a gain or loss on the entire interest. A gain or loss is recognised on the part that has been disposed of and a further holding gain or loss is recognised on the interest retained, being the difference between the fair value of the interest and the book value of the interest. The gains are recognised in the statement of comprehensive income. Any prior gains or loss recognised in other components of equity would now become realised in the statement of comprehensive income.

In this case, Cate should stop consolidating Date on a line-by-line basis from the date that control was lost. Further investigation is required into whether the holding is treated as an associate or trade investment. The agreement that Cate is no longer represented on the board or able to participate in management would suggest loss of significant influence despite the 35% of voting rights retained. The retained interest would be recognised at fair value.

An entity classifies a disposal group as held for sale if its carrying amount will be recovered mainly through selling the asset rather than through usage and intends to dispose of it in a single transaction.

The conditions for a non-current asset or disposal group to be classified as held for sale are as follows:

(i) The assets must be available for immediate sale in their present condition and its sale must be highly probable.
(ii) The asset must be currently marketed actively at a price that is reasonable in relational to its current fair value.
(iii) The sale should be completed or expected to be so, within a year from the date of the classification.
(iv) The actions required to complete the planned sale will have been made and it is unlikely that the plan will be significantly changed or withdrawn.
(v) management is committed to a plan to sell.

Cate has not met all of the conditions of IFRS 5 but it could be argued that the best presentation in the financial statements was that set out in IFRS 5 for the following reasons.

The issue of dilution is not addressed by IFRS and the decision not to subscribe to the issue of new shares of Date is clearly a change in the strategy of Cate. Further, by deciding not to subscribe to the issue of new shares of Date, Cate agreed to the dilution and the loss of control which could be argued is similar to a decision to sell shares while retaining a continuing interest in the entity. Also Date represents a separate line of business, which is a determining factor in IFRS 5, and information disclosed on IFRS 5 principles highlights the impact of Date on Cate's financial statements. Finally, the agreement between Date's shareholders confirms that Cate has lost control over its former subsidiary.

Therefore, in the absence of a specific Standard or Interpretation applying to this situation, IAS 8 *Accounting policies, changes in accounting estimates and errors* states that management should use its judgment and refer to other IFRS and the Framework.

Thus considering the requirements of IAS 27 (Para 32–37) and the above discussion, it could be concluded that the presentation based on IFRS 5 principles selected by the issuer was consistent with the accounting treatment required by IAS 27 when a parent company loses control of a subsidiary.

(d) Defined benefit plan

The Plan is not a defined contribution plan because Cate has a legal or constructive obligation to pay further contributions if the fund does not have sufficient assets to pay all employee benefits relating to employee service in the current and prior periods (IAS 19 Para 7). All other post-employment benefit plans that do not qualify as a defined contribution plan are, by definition therefore defined benefit plans. Defined benefit plans may be unfunded, or they may be wholly or partly funded. Also IAS 19 (Para 26) indicates that Cate's plan is a defined benefit plan as IAS 19 provides examples where an entity's obligation is not limited to the amount that it agrees to contribute to the fund. These examples include: (a) a plan benefit formula that is not linked solely to the amount of contributions (which is the case in this instance); and (b) those informal practices that give rise to a constructive obligation. According to the terms of the Plan, if Cate opts to terminate, Cate is responsible for discharging the

liability created by the plan. IAS 19 (Para 52) says that an entity should account not only for its legal obligation under the formal terms of a defined benefit plan, but also for any constructive obligation that arises from the enterprise's informal practices. Informal practices give rise to a constructive obligation where the enterprise has no realistic alternative but to pay employee benefits. Even if the Plan were not considered to be a defined benefit plan under IAS 19, Cate would have a constructive obligation to provide the benefit, having a history of paying benefits. The practice has created a valid expectation on the part of employees that the amounts will be paid in the future. Therefore Cate should account for the Plan as a defined benefit plan in accordance with IAS 19. Cate has to recognise, at a minimum, its net present liability for the benefits to be paid under the Plan.

3 Financial Instruments

(a) IAS 39 *Financial Instruments: Recognition and measurement* states that a derivative is a financial instrument:

(i) Whose value changes in response to the change in an underlying variable such as an interest rate, commodity or security price, or index; such as the price of edible oil
(ii) That requires no initial investment, or one that is smaller than would be required for a contract with similar response to changes in market factors; in the case of the future purchase of oil, the initial investment is nil and
(iii) That is settled at a future date.

However, when a contract's purpose is to take physical delivery in the normal course of business, then normally the contract is not considered to be a derivative contract, unless the entity has a practice of settling the contracts on a net basis. In this case the contracts will be considered to be derivative contracts and should be accounted for at fair value through profit and loss. Even though the entity sometimes takes physical delivery, the entity has a practice of settling similar contracts on a net basis and taking delivery, only to sell shortly afterwards. Hedge accounting techniques may be used if the conditions in IAS 39 are met.

IAS 39 permits hedge accounting under certain circumstances provided that the hedging relationship is: formally designated and documented, including the entity's risk management objective and strategy for undertaking the hedge, identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the entity will assess the hedging instrument's effectiveness; and expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk as designated and documented, and the effectiveness can be reliably measured.

Seltec would use cash flow or fair value hedge accounting. A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or a previously unrecognised firm commitment to buy or sell an asset at a fixed price or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. The gain or loss from the change in fair value of the hedging instrument is recognised immediately in profit or loss. At the same time the carrying amount of the hedged item is adjusted for the corresponding gain or loss with respect to the hedged risk, which is also recognised immediately in net profit or loss.

A cash flow hedge is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss [IAS 39]. The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised in OCI and reclassified to the income statement when the hedged cash transaction affects profit or loss [IAS 39].

IAS 39 is restrictive because of the difficulty of isolating and measuring the cash flows attributable to the specific risks for the non-financial items. Assuming all of the documentation criteria are met, Seltec can use hedge accounting but may favour a fair value hedge in order to reduce earnings volatility. All price changes of the edible oil will be taken into account including its type and geographical location and compared with changes in the value of the future. If the contracts have different price elements, then ineffectiveness will occur. Hedge accounting can be applied as long as the ineffectiveness is not outside the range 80%–125%.

IAS 39 defines an embedded derivative as a component of a hybrid instrument that also includes a non-derivative host contract, with the effect that some of the cash flows of the instrument vary in a way similar to a stand-alone derivative. As derivatives must be accounted for at fair value in the statement of financial position with changes recognised through profit or loss, so must some embedded derivatives. IAS 39 requires that an embedded derivative should be separated from its host contract and accounted for as a derivative when:

(i) the economic risks and characteristics of the embedded derivative are not closely related to those of the host contract;
(ii) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
(iii) the entire instrument is not measured at fair value with changes in fair value recognised in profit or loss.

If an embedded derivative is separated, the host contract is accounted for under the appropriate standard. A foreign currency denominated contract contains an embedded derivative unless it meets one of the following criteria:

(i) the foreign currency denominated in the contract is that of either party to the contract,
(ii) the currency of the contract is that in which the related good or service is routinely denominated in commercial transactions,
(iii) the currency is that commonly used in such contracts in the market in which the transaction takes place.

In this case the pound sterling is not the functional currency of either party, oil is not routinely denominated in sterling but dollars as most of Seltec's trade as regards the oil appears to be in dollars and the currency is not that normally used in business transactions in the environment in which Seltec carries out its business. Additionally, the economic risks are not closely related as currency fluctuations and changes in the price of oil have different risks. The host contract is not measured at fair value but would meet the definition of a derivative if it were a separate instrument with the same terms. The currency derivative should therefore be accounted for at fair value through profit or loss.

(b) Intangible assets and purchase of entities

Intangible assets are classified as having an:

(i) Indefinite life: No foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity; or a
(ii) Definite life: A limited period of benefit to the entity.

Factors that should be considered are:

(i) The entity's commitment to support the brand
(ii) The extent to which the brand has long-term potential that is not underpinned by short-term fashion or trends. That is, the brand has had a period of proven success
(iii) The extent to which the products carrying the brand are resistant to changes in the operating environment. These products should be resistant to changes in legal, technological and competitive environments.

The brand of oil, which has been in existence for many years, is likely to have an indefinite life as it has already proven its longevity having been successful for many years. However the oil named after a famous film star is likely to decline in popularity as the popularity of the film star declines. It is a new product and its longevity has not been proven and therefore it is likely to have a finite life. An intangible asset with an indefinite useful life should not be amortised. Its useful life should be reviewed each reporting period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate. The asset should also be assessed for impairment in accordance with IAS 36. The cost less residual value of an intangible asset with a finite useful life should be amortised on a systematic basis over that life. The amortisation method should reflect the pattern of benefits but if the pattern cannot be determined reliably, it should be amortised by the straight-line method.

A business combination is a transaction or event in which an acquirer obtains control of one or more businesses. A business is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return directly to investors or other owners, members or participants in the form of dividends, lower costs or other economic benefits to investors or owners. The two entitles do not meet the definition of a business in IFRS 3 (Revised) *Business Combinations* as they do not have any processes such as real estate management which are applied to the retail space that they own. The entities do not generate any outputs such as rental income. Therefore the acquisition should be treated as a purchase of assets.

4 (a) (i) The existing accounting model for leases has been criticised for failing to meet the needs of users of financial statements. It can be argued that operating leases give rise to assets and liabilities that should be recognised in the financial statements of lessees. Consequently, users may adjust the amounts recognised in financial statements in an attempt to recognise those assets and liabilities and reflect the effect of lease contracts in profit or loss. The information available to users in the notes to the financial statements is often insufficient to make reliable adjustments to the financial statements.

The existence of two different accounting methods for finance leases and operating leases means that similar transactions can be accounted for very differently. This affects the comparability of financial statements. Also current accounting standards provide opportunities to structure transactions so as to achieve a specific lease classification. If the lease is classified as an operating lease, the lessee obtains a source of financing that can be difficult for users to understand, as it is not recognised in the financial statements.

Existing accounting methods have been criticised for their complexity. In particular, it has proved difficult to define the dividing line between the principles relating to finance and operating leases. As a result, standards use a mixture of subjective judgments and rule based criteria that can be difficult to apply.

The existing accounting model can be said to be conceptually flawed. On entering an operating lease contract, the lessee obtains a valuable right to use the leased item. This right meets the Framework's definition of an asset. Additionally the lessee assumes an obligation to pay rentals that meet the Framework's definition of a liability. However, if the lessee classifies the lease as an operating lease, that right and obligation are not recognised.

There are significant and growing differences between the accounting methods for leases and other contractual arrangements. This has led to inconsistent accounting for arrangements that meet the definition of a lease and similar arrangements that do not. For example leases are financial instruments but they are scoped out of IAS 32/39.

(ii) An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. Holcombe has the right to use the leased plant as an economic resource because the entity can use it to generate cash inflows or reduce cash outflows. Similarly, Holcombe controls the right to use the leased item during the lease term because the lessor is unable to recover or have access to the resource without the consent of

the lessee or unless there is a breach of contract. The control results from past events, which is the signing of the lease contract and the receipt of the plant by the lessee. Holcombe also maintains the asset.

Unless the lessee breaches the contract, Holcombe has an unconditional right to use the leased item. Future economic benefits will flow to the lessee from the use of the leased item during the lease term. Thus it could be concluded that the lessee's right to use a leased item for the lease term meets the definitions of an asset in the Framework.

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. The obligation to pay rentals is a liability. Unless Holcombe breaches the contract, the lessor has no contractual right to take possession of the item until the end of the lease term. Equally, the entity has no contractual right to terminate the lease and avoid paying rentals. Therefore the lessee has an unconditional obligation to pay rentals. Thus the entity has a present obligation to pay rentals, which arises out of a past event, which is the signing of the lease contract and the receipt of the item by the lessee. Finally the obligation is expected to result in an outflow of economic benefits in the form of cash.

Thus the entity's obligation to pay rentals meets the definition of a liability in the Framework.

(b) (i) On sale of the building, Holcombe will recognise the following in the financial statements to 30 April 2010:

Dr Cash \$150m
Cr Office building \$120m
Cr Deferred Income (SOFP) \$30m
Recognition of gain on the sale of the building

Dr Deferred Income (SOFP) \$6m
Cr Deferred Income (I/S) \$6m
Release of the gain on sale of the building (\$30m/5 years)

Dr Operating lease asset \$63·89m
Cr Obligation to pay rentals \$63·89m
Recognition of the leaseback at net present value of lease payments using 8% discount rate

In the first year of the leaseback, Holcombe will recognise the following:

Dr Lease obligation – rentals \$16m
Cr Cash \$16m
Recognition of payment of rentals

Dr Interest expense \$5·11m
Cr Lease obligation \$5·11m
Recognition of interest expense (\$63·89m x 8%)

Dr Depreciation expense \$12·78m
Cr Right-of-use asset \$12·78m
Recognition of depreciation of operating lease asset over five years (\$63·89m/5 years). The statement of financial position will show a carrying value of \$51·11m being cost of \$63·89m less depreciation of \$12·78m.

(ii) Inflation adjustments should be recognised in the period in which they are incurred as they are effectively contingent rent and are not included in any minimum lease calculations. A contingent rent according to IAS 17 is 'that part of the rent that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time.' Thus in this case, Holcombe would recognise operating rentals of \$5 million in year 1, \$5 million in year 2 plus the inflation adjustment at the beginning of year 2, and \$5 million in year 3 plus the inflation adjustment at the beginning of year 2 plus inflation adjustment at the beginning of year 3. Based on current inflation, the rent will be \$5·2 million in year 2 and \$5·408 million in year 3.

Professional Level – Essentials Module, Paper P2 (INT)
Corporate Reporting (International) **June 2010 Marking Scheme**

				Marks
1	**(a)**		Consolidated SOCI	5
			Bochem	8
			Ceram	6
			Inventory	2
			Bond	4
			PPE	3
			Impairment of customer	2
			Employee benefits	2
			NCI	3
				35
	(b)		Amendments to IAS 39/IFRS 7	4
			Management of earnings	3
	(c)		Description of management of earnings	3
			Moral/ethical considerations	3
			Professional marks	2
				50
2			Deferred tax	5
			Investment in associate	5
			IFRS 5 Discussion and conclusion	8
			IAS 19 Discussion and conclusion	5
			Professional marks	2
				25
3			Hedge accounting	5
			Futures	5
			Embedded derivative	4
			Brands	5
			Business combinations	4
			Professional marks	2
				25
4	**(a)**	**(i)**	Subjective	7
		(ii)	Subjective	7
			Professional marks	2
	(b)	**(i)**	Recognition of gain	1
			Recognition of the leaseback	1
			Recognition of payment of rentals	2
			Recognition of interest expense and depreciation	2
		(ii)	Contingent rentals	3
				25