Suggested solution

Section A

Question 1

(a) Report

To: Directors of Pretalo

From: Chief accountant

Date: February 20X6

Advice on the consolidated financial statements

Introduction

This report provides advice on how to correct the accounting treatment of Soritti Co (Soritti), Trepilo Co (Trepilo), and the government grant in the consolidated financial statements for the year ended 31 December 20X5. It also contains a corrected consolidated statement of financial position as at 31 December 20X5.

(i) Soritti Co

The original 10% holding in the equity share capital of Soritti Co (Soritti) was correctly recognised as a financial asset and measured at its fair value of $66 million. Since no elections were made, this financial asset is measured at fair value through profit or loss.

On 31 December 20X5, Pretalo obtained control over Soritti in a step acquisition (control in stages). On this date, the previously recognised shareholding should be remeasured to its fair value of $70 million, with a gain of $4 million recognised in the investing category of the statement of profit or loss. The investment should be removed from financial assets and included in the calculation of goodwill at its fair value of $70 million.

The consideration transferred to achieve control should be measured at fair value. For the deferred cash, this should be measured at its present value of $123.81 million ($130m/1.05). A corresponding current liability should also be recognised.

On the acquisition date, the identifiable net assets of Soritti should be measured at fair value. The development asset is a non-financial asset. In accordance with IFRS 13 *Fair Value Measurement*, a fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use. As such, the fair value of the development asset is $80 million.

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The development asset will be uplifted from its carrying amount of $35 million to its fair value of $80 million. This increase of $45 million will reduce the amount of goodwill recognised at acquisition.

This uplift creates a taxable temporary difference of $45 million in the consolidated financial statements at the acquisition date. In accordance with IAS 12 *Income Taxes*, a deferred tax liability of $9 million ($45m x 20%) is recognised in the CSOFP. This will increase the amount of goodwill recognised.

Goodwill arising on the acquisition is $227.81 million. This is calculated as follows:

	$m	**$m**
Fair value of previous shareholding		70.00
Cash consideration		300.00
Deferred consideration		123.81
Non-controlling interest at acquisition		210.00
Fair value of identifiable net assets		
Carrying amount	440.00	
Fair value uplift	45.00	
Deferred tax liability	(9.00)	

		(476.00)

Goodwill at acquisition		227.81

(ii) Trepilo Co

Pretalo has obtained significant influence over Trepilo Co (Trepilo). In accordance with IAS 28 *Investments in Associates and Joint Ventures*, Pretalo has correctly recognised Trepilo as an associate. It should account for its investment using the equity method.

Pretalo has correctly recognised its investment at cost and, in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*, it has translated this by using the spot exchange rate on the date of the transaction.

Pretalo should recognise its share of the profits and other comprehensive income of the associate. The profits and other comprehensive income should be translated into dollars using the average rate of exchange of LR2.7 to $1.

At the reporting date, Pretalo should translate its investment in the associate using the closing exchange rate of LR2.9 to $1. This will give rise to a foreign exchange loss.

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	LR(m)	Exchange rate	$m
Cost	106.00	2.5	42.40
Share of profit (LR28 x 9/12 x 25%)	5.25	2.7	1.94
Share of OCI (LR10 x 9/12 x 25%)	1.88	2.7	0.69
Foreign exchange loss (bal. fig.)	-		(6.03)
	---------		---------
	113.13	2.9	39.00
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Pretalo should recognise ‘share of profits of associates’ of $1.94 million in the investing category of the statement of profit or loss. It should recognise other comprehensive income of $0.69 million and present this as an amount which will not be reclassified to the statement of profit or loss in the future.

At 31 December 20X5, the investment in the associate will have a carrying amount of $39.00 million.

A foreign exchange loss of $6.03 million is reported in other comprehensive income and presented as an amount which might be reclassified to profit or loss in the future.

(iii) Government grant

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* states that government grants are recognised in the statement of profit or loss on a systematic basis over the period in which the entity recognises the related costs for which the grants are intended to compensate.

In accordance with IAS 38 *Intangible Assets*, research costs are recognised in the statement of profit or loss. As such, the $10 million research-related grant should be removed from current liabilities and instead recognised in the operating category of the statement of profit or loss (either as income or as a deduction to the research expense).

In accordance with IAS 38, qualifying development expenditure is recognised as an intangible asset and amortised over its useful life. Pretalo chooses accounting policies which minimise its reported liabilities, meaning that it will deduct the grant from the carrying amount of the intangible development asset, in accordance with IAS 20.

As such, the $20 million development grant should be removed from current liabilities and deducted from the carrying amount of intangible assets.

Amortisation charges of $0.41 million (($25m/5) x 1/12) have been recognised in the statement of profit or loss. The correct amortisation charge is $0.08 million (($5m/5) x 1/12). Therefore, the amortisation charge should be reduced by $0.33 million ($0.41m - $0.08m).

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(iv) Consolidated statement of financial position

Consolidated statement of financial position
as at 31 December 20X5

	Draft	Remeasurement of financial asset	Deferred consideration	Fair value adjustment	Deferred tax	Share of associate profit and OCI	Foreign exchange loss	Grant recognition	Amortisation	Revised
	$m	$m	$m	$m	$m	$m	$m	$m	$m	$m
Assets										
Non-current assets										
Property, plant and equipment	401.00									401.00
Investment in associates	42.40					2.63	- 6.03			39.00
Intangible assets	345.00			45.00				- 20.00	0.33	370.33
Financial assets	104.00	- 66.00								38.00
Goodwill	122.60	70.00	123.81	- 45.00	9.00					280.41
	1,015.00									1,128.74
Current assets	273.00									273.00
Total assets	1,288.00									1,401.74
Equity										
Share capital	85.00									85.00
Translation reserve	15.00						- 6.03			8.97
Other components of equity	134.00					0.69				134.69
Retained earnings	413.00	4.00				1.94		10.00	0.33	429.27
	647.00									657.93
Non-controlling interest	326.00									326.00
Total equity	973.00									983.93
Liabilities										
Non-current liabilities										
Loans	80.00									80.00
Net deferred tax liabilities	99.00				9.00					108.00
	179.00									188.00
Current liabilities	136.00		123.81					- 30.00		229.81
Total liabilities	315.00									417.81
Total equity and liabilities	1,288.00									1,401.74

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(b) Supplier

In accordance with IAS 24 *Related Party Disclosures*, Pretalo and Capubalo Co (Capubalo) are related parties. This is because Capubalo is controlled by Pretalo's operations director, and the operations director is a member of Pretalo's key management personnel.

As a result, Pretalo must disclose the nature of the relationship between Pretalo and Capubalo, as well as other information, such as the amount of the transactions between them and any outstanding balances.

The finance director's request to exclude information about Capubalo in the financial statements is therefore not in accordance with IAS 24.

It may be that the finance director is unfamiliar with the requirements of IAS 24, which would be a breach of the ethical principle of professional competence and due care.

It seems more likely that the omission is intentional, which would demonstrate a lack of integrity. It would also demonstrate a lack of objectivity because the decision is being made to maximise the chances of maintaining the key customer contract. Although the finance director's decision may be motivated by a desire to protect the company's employees, this does not justify a breach of professional duties.

It should also be noted that Pretalo widely publicises its sustainability credentials, and most likely benefits from this. It is therefore disingenuous to downplay or hide its association with unethical suppliers. A truly sustainable business should be conducting supplier due diligence to ensure that sustainability is embedded throughout the supply chain. As it stands, it may be that Pretalo will be accused of greenwashing, which would damage its reputation.

I should discuss the requirements of IAS 24 with the finance director and recommend the appropriate disclosures. This discussion should be documented. I should also recommend to the finance director, or another relevant director, that Pretalo improves its supplier due diligence procedures.

If the finance director refuses to follow my suggestions, then I should raise the issue with other directors, including Pretalo's non-executive directors. I may also need to seek legal advice or advice from ACCA.

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Section B

Question 2

(a) Revenue

The artificial intelligence (AI) programme has stated that revenue should be recognised on the delivery of the report to the customer. This is incorrect. As stated in IFRS 15 *Revenue from Contracts with Customers*, an entity transfers control of a good or service over time if one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;
- The entity's performance creates or enhances an asset that the customer controls as the asset is created; or
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

The first criterion is not met, because the customer does not benefit from Drytat's work until the report is issued. The second criterion is not met because the customer does not control the report as it is created. However, the third criterion is met. This is because the report is specific to the customer and cannot be directed or distributed to another customer. In addition, if the customer terminates the contract, Drytat has an enforceable right to receive its incurred costs plus a typical margin of 30%. As such, revenue should be recognised over time, rather than at a point in time.

There are many ways of measuring progress towards satisfaction of a performance obligation. Drytat might measure this based on the time spent working on the contract compared to the total estimated time to complete. However, since costs are not incurred equally over the contract duration, it would be more accurate to measure progress based on costs incurred compared to total estimated costs.

The AI programme is correct that the revenue recognised should be net of sales tax.

Drytat offers credit periods to its customers. IFRS 15 states that an entity need not adjust the promised consideration for the effects of a significant financing component if the period between the customer receiving a promised good or service and the customer paying for the good or service is one year or less. This is the case with Drytat, as credit terms range from between three months to six months from the date the report is issued, and therefore it is not necessary to discount the transaction price to present value.

At the reporting date, the difference between revenue recognised on an ongoing contract and the cash received (most likely nil) is recognised as a contract asset rather than as a

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receivable. This is because Drytat must complete the report before it is entitled to payment, and therefore the right to consideration is not unconditional.

(b) Land

The land was originally reported as property, plant and equipment (PPE) because it was intended for owner-occupation. However, during the year ended 31 December 20X5, the use of the land changed and now meets the definition of investment property. This is because it is held to earn rental income (and, as discussed later, the lease is not a finance lease).

IAS 40 *Investment Property* states that a change in management's intentions for the use of land or property does not provide evidence of a change in use. However, the inception of the lease on 1 November 20X5 does provide clear evidence of a change in use.

IAS 40 states that when owner-occupied property becomes investment property measured at fair value, the transfer is treated like a revaluation under IAS 16 *Property, Plant and Equipment*. Therefore, on 1 November 20X5, the land should be transferred from property, plant and equipment to investment properties at its fair value of $3.3 million. The carrying amount of the land on this date is the original cost of $3 million and so a gain of $0.3 million ($3.3m - $3.0m) is reported in other comprehensive income and presented as an item which will not be reclassified to the statement of profit or loss.

In accordance with IFRS 16 *Leases*, the lease agreement should be classified as an operating lease. This is because land is deemed to have an indefinite useful life, and there is no indication that ownership of the land transfers to Oodox at the end of the lease term.

Tutorial note*: Although the lease payments are substantially the same as the asset's fair value, they will be significantly lower if discounted to present value.*

IFRS 16 states that receipts from operating leases are recognised as income on a straight-line basis (or another systematic basis). In the year ended 31 December 20X5, income of $25,000 ($75,000 x 2/6) should be recognised in the investing category of the statement of profit or loss. A corresponding current asset (accrued income) of $25,000 should be recognised in the statement of financial position.

At the reporting date, and in accordance with the fair value model in IAS 40, the land will be remeasured to its fair value of $3.4 million. The gain of $0.1 million ($3.4m - $3.3m) is recognised in the investing category of the statement of profit or loss.

(c) Financial asset

Drytat's business model involves holding financial assets to maturity but also making some sales. Therefore, in accordance with IFRS 9 *Financial* Instruments, the financial asset should be measured at fair value through other comprehensive income.

The financial asset should initially be measured at its fair value of $15 million.

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Interest income is based on the effective rate of interest. This amounts to $0.9 million ($15m x 6%) in the year ended 31 December 20X5. This interest is recognised in the investing category of the statement of profit or loss, and it also increases the carrying amount of the financial asset.

The cash receipt of $0.6 million ($15m x 4%) reduces the carrying amount of the financial asset.

At the reporting date, the financial asset must be remeasured to its fair value of $11 million. The loss arising is calculated as follows:

Opening	**Interest income**	**Interest received**	**Subtotal**	**Loss (bal.fig.)**	**Fair value**
$m	**$m**	**$m**	**$m**	**$m**	**$m**
15.0	0.9	(0.6)	15.3	(4.3)	11.0

The loss of $4.3 million is recognised in other comprehensive income. It is presented as an item which may be reclassified to profit or loss in the future.

Expected credit losses

Credit risk appears to have increased significantly. This is because the cyber-attack has substantially affected Erolt's ability to sell its products to consumers, therefore impacting its ability to generate cash. This will make it harder for Erolt to pay the interest due on its debts. This is also evidenced by the fact that other similar retailers have seen an increase in the fair values of their bonds, whereas the fair value of Erolt's bonds has declined. Expected credit losses should therefore be measured using the lifetime expected credit losses of $1.8 million.

The financial asset is measured at fair value through other comprehensive income. As such, expected credit losses are recognised in the statement of profit or loss with a corresponding amount recognised in other comprehensive income. Therefore, $1.8 million will be charged to the investing category of the statement of profit or loss, and $1.8 million will be credited to other comprehensive income.

Tutorial note: there is no indication in the scenario that the financial asset is credit-impaired.

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Question 3

(a) Climate-related risks

A sustainability matter is material from a financial perspective if it could reasonably be expected to have a material influence on the entity's financial position, financial performance, cash flows, access to finance, or cost of capital over the short- medium- or long-term.

Increased levels of flooding and drought are impacting crop yields, which is driving up suppliers' prices. If Greenchaff increases selling prices, then it might start to lose customers, which will negatively impact its cash flows and profits. This may also make it harder to obtain finance in the future. Alternatively, if Greenchaff does not increase selling prices, then its profit margins, and net cash flows, will fall.

Greenchaff's warehouses are at risk of flooding, which may cause business interruption and negatively impact Greenchaff's reputation and/or its revenues. It may also lead to inventory damage; the inventory would need to be written off to the statement of profit or loss. If the warehouses are flooding regularly, then this might be an indicator of impairment; impairment losses would reduce profits in the statement of profit or loss, which may increase the perception of risk to future investors and lenders.

A carbon tax is being introduced in Greenchaff's jurisdiction. Unless Greenchaff continues to reduce its greenhouse gas (GHG) emissions, it may be liable to this tax in the future, thus reducing its net cash inflows.

(b) GHG emissions disclosure

Greenchaff has provided no comparative data about GHG emissions, even though this is a requirement of ESRS 1 *General Requirements*.

There are several reasons why the disclosure note does not comply with the requirements of ESRS E1 *Climate Change*:

- Greenchaff has presented its GHG emissions on a net basis, but ESRS E1 requires that GHG emissions are presented gross.
- Greenchaff has only separately disclosed its Scope 1 GHG emissions, but IFRS S2 requires that disclosure of GHG emissions is broken down into Scope 1, Scope 2 and Scope 3.
- The disclosure of Scope 1 GHG emissions should include the percentage of Scope 1 GHG emissions from regulated emission trading schemes.
- The disclosure of Scope 2 GHG emissions should include the gross location-based Scope 2 GHG emissions, and the gross market-based Scope 2 GHG emissions.

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- Greenchaff should have provided additional information about how it measured its GHG emissions, including significant assumptions and emissions factors.
- The disclosure of Scope 3 GHG emissions should include emissions in metric tonnes of CO_2eq from each significant Scope 3 category.
- The disclosure of total GHG emissions should be presented with a disaggregation which makes a distinction between the total GHG emissions derived from measuring Scope 2 GHG emissions using the location-based method, and the total GHG emissions derived from measuring Scope 2 GHG emissions using the market-based method.
- Greenchaff has not disclosed it GHG emissions intensity (GHG emissions per net revenue). The net revenue figure used in the calculation should be reconciled to the financial statements.

(c) (i) Share options

In accordance with IFRS 2 *Share-based Payment*, an equity-settled share-based payment is measured using the fair value at the grant date, which was $6.30 per option.

The transaction should be recognised over the three-year vesting period.

The greenhouse gas (GHG) emissions condition is not a market-based condition; therefore, along with the service condition, it is considered by adjusting the number of equity instruments included in the measurement of the transaction.

In the year ended 31 December 20X4, the GHG emissions target was expected to be met, and so the expense recognised was as follows:

120 x 20,000 x $6.30 x 1/3 = $5.04 million

This expense would have been recognised in the operating category of the statement of profit or loss, with a corresponding credit entry recognised in equity.

In the year ended 31 December 20X5, the GHG emissions target was not expected to be met. Therefore, the expense and equity recognised in the prior year should be reversed. This means that the equity of $5.04 million is derecognised. A credit (income) of $5.04 million is recognised in the operating category of the statement of profit or loss.

(c) (ii) Management estimates and judgements

The most important judgement which determines the reporting impact in the current year is whether the GHG emissions target will be met. If management had expected that this target would be met by the vesting date, then an expense (rather than an income) would have been recognised in the current period. This would have been calculated as follows:

(100 x 20,000 x $6.30 x 2/3) - $5.04m = $3.36 million

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In other words, if the GHG target was expected to be met, profits in the current year would be $8.4 million ($3.36m + $5.04m) lower.

Another key estimate is the number of senior managers who are expected to satisfy the vesting conditions. Normally, the higher this figure, the greater the expense recognised. However, this estimate had no impact in the current year because the non-market condition was not expected to be met and so the amounts recognised in the previous year were reversed.

The measurement of the fair value of an option incorporates an estimate of expected share price volatility. The higher the fair value of the option at the grant date, the greater the total expense recognised over the life of the scheme, assuming that the options vest.

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Mark scheme

Question 1

			Marks
a	**i**	Remeasurement of Soritti Consideration Fair value adjustment Deferred tax Goodwill calculation	3 2 4 2 3
Maximum 10 marks			
a	**ii**	Equity method Translation and forex	5 6
Maximum 8 marks			
a	**iii**	Application of IAS 38 Application of IAS 20 Amortisation	2 4 1
Maximum 5 marks			
a	**iv**	Investment in associates Intangible assets Financial assets Goodwill Translation reserve Other components of equity Retained earnings Net deferred tax liabilities Current liabilities	1 3 1 1 1 1 4 1 2
Maximum 13 marks			
b		Related parties Ethical principles Actions	3 4 4
Maximum 8 marks			

Professional skills marks:

Communication

General report format and structure (use of headings, sub-headings and an introduction)

Style, language and clarity (tone of report response, appropriate use of the tools, easy to follow and substantive amount of content)

Analysis and evaluation

Logical and structured approach taken to calculations, which are well presented and easy to follow, and which are used to inform the accounting advice offered

Maximum 6 marks

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Total 50 marks

Question 2

			Marks
a		Revenue over time Stage of completion Sales tax Discounting Contract asset	6 2 1 2 2
Maximum 9 marks			
b		Investment property change in use Lease classification/accounting Remeasurement of investment property at reporting date	4 5 2
Maximum 8 marks			
c		Classify as FVOCI Accounting treatment of asset Expected credit losses	2 7 4
Maximum 9 marks			

Professional skills marks:

Scepticism

Scepticism is demonstrated by questioning and challenging the accounting treatment presented

Analysis and evaluation

Logical and structured approach taken to calculations, which are well presented and easy to follow, and which are used to inform the accounting advice offered

Maximum 4 marks

Total 30 marks

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Question 3

			Marks
a		1 mark per point	4
Maximum 4 marks			
b		No comparatives	1
		Net rather than gross	1
		No separate Scope 1, 2, 3	1
		Scope 1 information	1
		Scope 2 information	1
		Additional measurement information	1
		Scope 3 categories	1
		Disaggregated totals	1
		GHG intensity	1
Maximum 6 marks			
c	**i**	IFRS 2 principles	1
		Calculations and treatment	5
Maximum 4 marks			
c	**ii**	GHG emission expectation	3
		Leavers	2
		Fair value of option	1
Maximum 4 marks			

Professional skills marks:

Commercial acumen

Commercial acumen is demonstrated by providing advice which is relevant to Greenchaff

Maximum 2 marks

Total 20 marks

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