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# Answers

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- 1 (a) Consolidated statement of profit or loss and other comprehensive income for the Moorland Group for the year ended 30 June 2017

	Total \$m
Revenue	887
Cost of sales	(531)
Gross profit	<u>356</u>
Administrative costs	(142)
Other expenses	(85.9)
Operating profit	<u>128.1</u>
Net finance costs	(23.8)
Profit before tax	<u>104.3</u>
Income tax expense	(50.2)
Profit for the year	<u>54.1</u>
Other comprehensive income	
Items that will not be reclassified to profit or loss	
Gains on property revaluation	61.8
Pension remeasurement loss	(4.2)
	<u>57.6</u>
Items that may be reclassified to profit or loss	
Exchange losses	(85.9)
Other comprehensive income	<u>(28.3)</u>
Total comprehensive income for year	<u>25.8</u>
Non-controlling interest profits (W9)	13.4
Shareholders of Moorland profits (balance)	<u>40.7</u>
Profit for the year	<u>54.1</u>
Non-controlling interest total comprehensive income (W9)	<u>20.2</u>
Shareholders of Moorland total comprehensive interest (W10)	5.6
Total comprehensive income for the year	<u>25.8</u>

**Working 1: Consolidation schedule**

	Moorland	Lyndhurst	Tybull (W5)	Adjust (W5)	Consol
	\$m	\$m	\$m		
Revenue	580	202	135	(30)	887
Cost of sales	(376)	(96)	(89)	30	(531)
Gross profit	204	106	46		356
Administrative costs	(95)	(24)	(13)		(142)
Incorrect capitalisation of legal fee (W2)	(2)				
Gain on step acquisition (W2)	7				
Service cost (W8)	(15)				
Other expenses	(39)	(20)	(10)		(85.9)
Goodwill impairment Lyndhurst (W3)		(10.5)			
Goodwill impairment Tybull (W4)			(6.4)		
Operating profit	60	51.5	16.6		128.1
Net finance costs	(12)	(6)	(4)		(23.8)
Pension (W8)	(1.8)				
Profit before tax	46.2	45.5	12.6		104.3
Income tax expense	(18)	(12)	(7)		(50.2)
Deferred tax adjustment (W7)	(13.2)				
Profit for the year	15	33.5	5.6		54.1
Other comprehensive income					
Items that will not be reclassified to profit or loss					
Gains on property revaluation (W7)	44.8	17	0		61.8
Pension remeasurement loss (W8)	(4.2)				(4.2)
Items that may be reclassified to profit or loss					
Exchange loss on translation of Tybull (W6)	(85.9)				(85.9)
Other comprehensive income	(45.3)	17			(28.3)
Total comprehensive income for year	(30.3)	50.5	5.6		25.8

**Working 2: Lyndhurst – step acquisition**

Moorland obtains control over Lyndhurst on 1 July 2016. Lyndhurst therefore should be consolidated for the whole year (W1).

On a step acquisition IFRS 3 *Business Combinations* requires the original 40% investment to be recognised at its acquisition-date fair value and the resulting gain or loss in profit or loss or other comprehensive income. The original shareholding would have been equity accounted as follows:

	\$ million
Cost of investment (40%)	100
Plus 40% of (\$250m – \$230m)	8
Investment in associate at 30 June 2016	108

Since the fair value of a 40% interest at 1 July 2016 is \$115 million, a gain of \$7 million (\$115m – \$108m) should be recorded within profit or loss of Moorland (W1). In addition, the legal fees of \$2 million should not have been included in the cost of investment but should be expensed (W1).

**Working 3: Lyndhurst – goodwill impairment**

The goodwill impairment of Lyndhurst will be calculated as follows:

	\$ million
Fair value of original 40% investment at 1 July 2016	115
Fair value of extra 20% acquired (\$64m – \$2m)	62
Fair value of 40% non-controlling interest at 1 July 2016	115
Less net assets at acquisition	(250)
Goodwill at acquisition	42
Impairment at 25% (W1)	(10.5)
Goodwill for consolidated SFP (not required)	31.5

#### Working 4: Tybull goodwill

The goodwill impairment of Tybull will be calculated as follows:

	dinar million
Cost	990
Less net assets at acquisition	(888)
Goodwill at acquisition	102
Impairment at 25%	(25.5)
Goodwill for consolidated SFP	76.5

An exchange difference will arise on goodwill in the current year by comparing goodwill at the opening rate of exchange with goodwill at the closing rate of exchange.

	\$m
Goodwill of dinar 102m at opening rate of \$1:3.5 dinar	29.1
Impairment of dinar 25.5m at average rate of \$1:4 dinar	(6.4)
Exchange loss on goodwill (balancing figure)	(7.4)
Goodwill of dinar 76.5m at closing rate of \$1:5 dinar	15.3

Consequently \$6.4 million will be expensed to other expenses (W1). A loss arises in other comprehensive income of \$7.4 million (W6).

#### Working 5: Tybull translation

The intra-group transaction between Tybull and Moorland will need to be cancelled in the consolidated financial statements. Since the profits of Tybull will be translated at the average rate of exchange of \$1:dinar 4, the adjustment will be \$30m (120m dinar/4 (W1)). Unrealised profit of dinar 36m ((dinar 120m x 60/160) x 80%) will arise on the group transaction. Tybull's profit for the year will be adjusted for the extra depreciation arising from the fair value adjustment. Additional depreciation of dinar 24m will be expensed (48m/2) as part of cost of sales.

Tybull's profits will then be translated at the average rate of exchange as follows:

	dinar (millions)	\$ (millions)
Revenue	540	135
Cost of sales	(296)	(74)
Depreciation adjustment	(24)	(6)
PURP	(36)	(9)
Administrative costs	(52)	(13)
Other expenses	(40)	(10)
Net finance costs	(16)	(4)
Income tax expense	(28)	(7)
Profit after tax	48	12

Note that cost of sales will be \$89m (\$74m + \$6m + \$9m) (W1).

#### Working 6: Other exchange differences on Tybull

Further exchange differences will be recorded in other comprehensive income on the opening net assets of Tybull and their profit for the year.

The opening net assets are given as dinar 888 million. The exchange difference is calculated by translating this at the opening and closing exchange rates.

dinar 888 million at opening rate of \$1:dinar 3.5 = \$253.7 million.

dinar 888 million at closing rate of \$1:dinar 5 = \$177.6 million.

An exchange loss of \$76.1 million arises (\$253.7 m – \$177.6 m).

The revised profit of Tybull for the year is dinar 48 million (W5).

An exchange difference arises by comparing the profit at the average rate of exchange (\$12 million (W5)) with the closing rate of \$1:5 dinar. Profit of dinar 48 million at closing rate of 5 = \$9.6 million. A further exchange loss arises of \$2.4 million (\$12m – \$9.6m). (**Tutorial note:** This excludes the goodwill impairment of Tybull since this forms part of the exchange difference on goodwill (W6))

Total exchange differences to total comprehensive income are therefore \$85.9 million (\$7.4 million (W4) + \$76.1 million + \$2.4 million).

#### Working 7: Revaluation of property, plant and equipment

A revaluation gain arises on the property of Moorland of \$64 million (\$450m – \$386m). This will be included within other comprehensive income. A deferred tax liability will arise of \$69 million ((\$450m – \$220m) x 30%) at 30 June 2017. The movement on deferred tax should be posted each year and the opening deferred tax balance would have been \$36.6 million

(( $\$422\text{m} - \$300\text{m}$ )  $\times$  30%). Deferred tax must be reported in the financial statements to match the corresponding gains and losses. The movement in deferred tax is an increase of  $\$32.4$  million ( $\$69\text{m} - \$36.6\text{m}$ ). Deferred tax on the revaluation gain must be reported in OCI of  $\$19.2$  million ( $\$64\text{m} \times 30\%$ ). This means that  $\$13.2$  million ( $\$32.4\text{m} - \$19.2\text{m}$ ) must be added to the tax expense in the year. The necessary adjustment is summarised as follows:

Dr PPE	\$64m	
Dr Income tax expense	\$13.2m	
Cr Deferred tax		\$32.4m
Cr Revaluation surplus/OCI ( $\$64\text{m} - \$19.2\text{m}$ )		\$44.8m

#### Working 8: Pension scheme

The benefits paid can be ignored as they will not alter the net pension deficit for the year. The service cost component and net interest component must be expensed against profit or loss. The cash contributions will reduce Moorland's cash balance but increase the pension scheme's assets. A remeasurement component should be calculated and recorded in other comprehensive income for the year as follows:

	\$ millions
Net deficit at 30 June 2016	30
Net finance cost for the year ( $30 \times 6\%$ )	1.8
Service cost component	15
Cash contributions	(9)
Remeasurement loss (balancing figure)	4.2
Net deficit at 30 June 2017	<u>42</u>

The necessary adjustment is summarised as follows:

Dr Finance cost	\$1.8m	
Dr Administrative expenses	\$15m	
Dr OCI	\$4.2m	
Cr Pension liability		\$12m
Cr Cash		\$9m

#### Working 9: Non-controlling interests

##### Non-controlling interest share of profits:

Lyndhurst: $40\% \times \$33.5\text{m}$ (W1)	\$m 13.4
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##### Non-controlling interest share of total comprehensive income:

Lyndhurst $40\% \times \$50.5\text{m}$ (W1)	\$m 20.2
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#### Working 10: Total comprehensive income Moorland

	\$m
Moorland profit for the year (W1)	15
Moorland property revaluation	44.8
Pension remeasurement loss	(4.2)
Lyndhurst ( $60\% \times \$50.5\text{m}$ ) (W1)	30.3
Tybull ( $100\% \times \$5.6\text{m}$ ) (W1)	5.6
Exchange loss (W6)	(85.9)
	<u>5.6</u>

(b) IFRS 8 *Operating Segments* describes an operating segment as a component of an entity:

- (i) Which engages in business activities from which it may earn revenues and incur expenses;
- (ii) Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance;
- (iii) For which discrete financial information is available.

There is a considerable amount of subjectivity in how an entity may apply these criteria to its choice of operating segments. Usually an operating segment would have a segment manager who maintains regular contact with the chief operating decision maker to discuss operating activities, financial results, forecasts or plans for the segment. Therefore segment managers could have overall responsibility for a particular product, service line or geographical area and so there could be considerable overlap in how an entity may apply the criteria. In such situations the directors of Moorland should consider the core principles of the standard. Information should be disclosed to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Since Tybull is the only overseas subsidiary, it is likely that separate disclosure is necessary so that users can better assess the performance of Tybull and its significance to the group. The directors should consider whether there are other segments which exhibit similar long-term financial performance and similar economic characteristics to Tybull. In such circumstances it is possible to aggregate the operating segments into a single segment. For example, the segments should have products of a similar nature and similar methods to distribute their products. The segments should also have similar types of customer, production processes and regulatory environment. The directors of Moorland would need to assess whether such aggregation would limit the usefulness of the disclosures for the users of the financial statements. For example, it would no longer be possible to assess the gross margins and return on capital employed for Tybull on an individual basis, without referring to its individual financial statements.

Operating segments can be reclassified where an entity changes its internal organisational structure. As Tybull has not changed its organisational structure, it is unlikely that it would be able to argue for a reclassification of its operating segments. Should the directors of Moorland decide to reclassify the operating segments and combine Tybull with other segments, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would need to be applied. A retrospective adjustment would be required to the disclosures and the change would need to be justified. An entity should only change its policy if it enhances the reliability and relevance of the financial statements. This would appear unlikely given the circumstances.

- (c) The purpose of group accounts is to show the transactions of the group as if it is a single economic entity. Moorland has control over the economic resources of each subsidiary and therefore a clear picture of the group's position and performance can only be ascertained by combining the financial statements of the parent and all subsidiaries. 100% of the assets, liabilities, income and expenses are added together to reflect the parent entity's control over those resources. Part-ownership is reflected through the inclusion of a non-controlling interest.

Transactions between parent and subsidiaries are a perfectly normal aspect of business relationships. There are no specific rules as to what level of mark-up should be applied to such transactions. Entities are therefore free to determine the sales price which they wish on intra-group transactions and it need not be at arm's length. Intra-group transactions and unrealised profits are eliminated so that the consolidated financial statements best reflect substance and faithfully represent the transactions which pertain to the group. It is true that the mark-up or margin chosen will not alter the profits of the group, however, the impact upon the individual financial statements should still be considered.

A clear self-interest threat arises from the intention to sell the shares in Tybull. The directors of Moorland have an incentive to manipulate the profits in order to secure as high a price as possible for the sale of the shares. This would be detrimental to the bidder and is a clear ethical issue. The directors should consider the guiding principles of the IASB's *Conceptual Framework* when considering how the mark-up will impact on the profits of the individual group members. The *Framework* emphasises that for financial information to be useful, it must be relevant and faithfully represent what it purports to represent. Faithful representation requires accounting policies chosen to be neutral and objective. It could be argued that by deliberately inflating the mark-up, the directors are presenting financial statements which are not neutral or free from bias.

When assessing whether an ethical issue has arisen from the choice of mark-up, consideration of IAS 24 *Related Parties* is relevant. Moorland and Tybull are related parties and the transfer of goods is a related party transaction. Information must be disclosed on related party transactions necessary for users to understand the potential effect of the relationship on the financial statements. This is required since related party transactions are often not carried out on an arm's length basis. Indeed, related party transactions include transfers of resources, services or obligations regardless of whether a price is charged. Provided that the full effects of the transaction were properly disclosed, no ethical issue would arise from selling the goods at an unusually high margin.

- 2 (a) According to IFRS 10 *Consolidated Financial Statements*, an investor controls an investee when the investor has power over the investee, exposure, or rights, to variable returns from its involvement with the investee and the ability to use its power over the investee to affect the amount of the investor's return. Formatt makes all of the operational decisions as regards Font and the only decisions which need the approval of both Formatt and Loft are those which are outside normal operational decisions. These are protective rights for Loft and do not prevent Formatt from having power over Font. The concept of returns is quite a broad one and would include a return from the bonds purchased by Formatt in Font. Hence, Formatt has exposure to positive and possibly negative returns as the bondholders' return is based upon the performance of Font. Formatt is therefore exposed to variable returns from its involvement with Font. Formatt also has the right to appoint the general manager of Font and thus, together with the operational control exercised by Formatt, this power can be used to affect the amount of the investor's return. Thus, the conditions set out in IFRS 10 appear fulfilled, and it can be concluded that Formatt controls Font. Therefore, Formatt should consolidate Font as a subsidiary in its financial statements as of 30 November 2017.

As Formatt held 49.1% of the shares of Protect, it does not have a majority. The second highest shareholding is one of 20% which can indicate significant influence but this does not prevent Formatt from controlling Protect. Formatt only needs the support or the absence of one of the other shareholders to hold a majority of the voting rights. Formatt has also been able to sustain a majority representation in the management committee, showing that it can dominate the election process. Additionally, there had not been complete representation of the shareholders at the last four annual general meetings which has meant that Formatt could control the voting at such meetings. In the event of a shareholder wishing to sell its shares, Formatt can protect its position if it so wishes by having first refusal on the purchase of such shares. Therefore, Formatt should consolidate Protect as a subsidiary in its financial statements as of 30 November 2017.

- (b) IFRS 15 *Revenue from Contracts with Customers* states that an entity is a principal where the entity controls the promised good before transfer to the customer. However, the entity is an agent where the performance obligation is to arrange provision of the goods by another party. Although Formatt has subcontracted the manufacturing of the equipment to a supplier, the development of the specification, the manufacturing of the equipment, and the overall management of the contract are not distinct because they are not separately identifiable and thus there is a single performance obligation. The customer has contracted with Formatt so that the various elements of the contract are integrated as one obligation.

Therefore, Formatt controls the specialised equipment before the equipment is transferred to the customer and is therefore the principal in this transaction. Formatt is also responsible for any defects. The supplier cannot decide to use the specialised equipment for another purpose as the equipment must be delivered to the customer to fulfil the promise in the contract. Formatt has the responsibility for fulfilling the contract, determines the price of the contract, is not paid on a commission basis and has the credit risk.

- (c) The *Conceptual Framework* defines an asset as 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. The existing *Conceptual Framework* does not define control. The Exposure Draft: *Conceptual Framework for Financial Reporting* defines an asset as a present economic resource controlled by the entity as a result of past events. It goes on to say that control links the economic resource to the entity and that assessing control helps to identify what economic resource the entity should account for. For example, if an entity has a proportionate share in a property without controlling the entire property, the entity's asset is its share in the property, which it controls, not the property itself, which it does not. An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits which flow from it. However, risks and rewards can be a helpful factor to consider when determining the transfer of control.

The entity should consider whether the contractual rights to the cash flows from the asset have expired as, if so, the asset should be derecognised. Second, if the contractual rights to the cash flows have not expired, as is the case with Formatt, the entity should consider whether it has transferred the financial asset. When an entity transfers a financial asset, it should evaluate the extent to which it retains the risks and rewards. IFRS 9 *Financial Instruments* provides three examples of when an entity has transferred substantially all the risks and rewards of ownership. These are an unconditional sale of a financial asset, sale of a financial asset with an option to repurchase the financial asset at its fair value and sale of a financial asset which is deeply 'out of the money'. Thus in this case, even though most of the cash flows which are derived from the loan are passed on to Window (up to a maximum of \$7 million), Formatt is essentially still in 'control' of the asset as the risks and rewards have not been transferred because of the subordinated retained interest. Formatt's residual interest also absorbs the potential credit losses.

If Formatt has neither retained nor transferred substantially all of the risks and rewards of ownership, the assessment of control is important. If control has been retained, the entity would continue to recognise the asset to the extent of its continuing involvement.

However, as Formatt has retained the risks and rewards, it should recognise the financial asset in the statement of financial position and the 12-month expected credit losses.

- 3 (a) IFRS 15 *Revenue from Contracts with Customers* sets out the core principle that an entity will recognise revenue to depict the transfer of promised goods or services to customers in an amount which reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This principle is delivered through a five-step model. Once the contract with the customer has been identified, step 2 of the model identifies those elements of the contract which should be accounted for separately. The performance obligations should be identified at the beginning of the contract by identifying distinct goods or services in the contract. To do so, the entity should identify all the goods and services which have been promised. The distinct performance obligations are the units of account which determine when and how revenue is recognised. A good or service is distinct only if the customer can benefit from the good or service either on its own or together with other resources available to the customer and the good or service is separately identifiable from other promises in the contract.

A customer can benefit from a good or service on its own if it can be used, consumed, or sold to generate economic benefits. Determining whether a good or service is distinct within the context of the contract requires assessment of the contract terms and the intent of the parties.

Thus in the case of Darlatt, the entity is required to assess whether the deliverables it has promised to the customer give rise to separate performance obligations. The purchase of the wind turbine and the maintenance contract are obviously separate performance obligations. However, the two warranties require further consideration. The nature of the warranty will determine the accounting impact. IFRS 15 states that an entity accounts for a warranty as a separate performance obligation if the customer has the option to purchase the warranty separately. An entity accounts for a warranty as a cost accrual if it is not sold separately, unless the warranty is to provide the customer with a service in addition to assurance that the product complies with agreed specifications. The free warranty simply provides the customer with the assurance that the wind turbine meets the agreed specification and thus is not a separate performance obligation. Where the warranty provides an additional service as is the case with the ten-year warranty, then the income will be treated as deferred revenue.

Once the separate performance obligations have been identified, then the transaction price is allocated to them based on the relative stand-alone selling prices of the goods or services promised. This allocation is made at contract inception and not adjusted to reflect subsequent changes in the stand-alone selling prices of those goods or services. The best evidence of stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately.

Therefore, the wind turbine will be allocated with  $(\$3.2m/\$4.1m \times \$3.6m)$ , i.e. \$2.8 million and the maintenance contract with  $(\$0.9m/\$4.1m \times \$3.6m)$ , i.e. \$0.8 million of the total revenue. Thus the maintenance contract and additional warranty will be recognised over time and the sale of the wind turbine and free warranty will be recognised at a point in time. Where revenue is recognised over time, a method should be used which best reflects the pattern of transfer of goods or services to the customer. In this case, it would appear that both of the above elements would be recognised over 10 years.

- (b) The contract is not accounted for under IFRS 9 *Financial Instruments*. The contract is simply a right and an obligation to exchange economic resources (or to pay or receive the difference in values between two economic resources if the contract will be settled net). The entity should therefore apply the general measurement concepts in the *Conceptual Framework* and the relevant IFRS.

The result in this case would be that the contract would be measured at zero and hence is not recognised unless the contract is onerous.

If an entity enters into a forward contract to purchase a resource at a future date, the entity's asset is normally its right to buy the underlying resource, not the underlying resource itself. However, there may be circumstances in which the terms of a forward contract to purchase a resource give the purchaser control of that resource. In such circumstances, the purchaser should identify both an asset (the underlying resource which it already controls) and a liability (its obligation to pay for the resource). In practice, obligations under contracts which are not performed would not be accrued in the financial statements.

For example, the liability for the steel ordered but not yet received would not generally be recognised as a liability in the financial statements. If historical cost measurement is applied to the contract, the contract would be measured at zero which has the same practical effect as not recognising the contract unless it is onerous. However, in order to achieve consistency with the existing requirements in IAS 2 *Inventories*, a contract would be regarded as onerous if the contractual price payable for the inventory exceeded its net realisable value. At 31 August 2017, the price which Dalatt would have to pay for the steel would be  $(2,000 \text{ tonnes} \times \text{€}400/1.75)$ , i.e. \$457,142. At the time of the contract, the contract price would have been  $(2,000 \text{ tonnes} \times \text{€}400/2)$ , i.e. \$400,000. Therefore it can be argued that a provision of \$57,142 should be made as the fall in the dollar/euro exchange is unlikely to be reversed.

The deposit paid of €100,000 is a non-monetary item as it is non-refundable. IAS 21 *The Effects of Changes in Foreign Exchange Rates* states that the essential feature of a non-monetary item is the absence of a right to receive or an obligation to deliver a fixed or determinable number of units of currency. The standard further gives an example of non-monetary items as amounts prepaid for goods and services. Non-monetary items which are measured in terms of historical cost or fair value are translated using the exchange rate at the date of the transaction or at the date when the fair value was measured. Thus the deposit will be stated at \$50,000 in the financial statements under current assets.

- (c) Development is defined in IAS 38 *Intangible Assets* as the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use. Commercial production is not defined in IAS 38 but it would suggest that it includes an approved technology or any output from its use being available for sale to customers. The wind farm is essentially a test site to create knowledge about the design of future wind turbines to create a more efficient and cost effective product. There has not been commercial production of the wind turbine because of doubts over its durability and therefore the designation of the farm as a development project should remain until the technology has been proven. Once commercial production commences, then the development phase is complete.

During the development phase, these costs should be treated as intangible assets if they meet the capitalisation requirements in IAS 38. These requirements include its technical feasibility for use or sale, the entity's intention to complete the intangible asset and use or sell it, the generation of probable future economic benefits, the availability of adequate resources to complete the development and the entity's ability to measure reliably the expenditure on the development. However, judgement should be used to determine whether these assets should be recorded as property, plant and equipment as they are actually producing energy.

A further question is whether the income generated from the wind farm should be offset against the development cost or recognised in profit or loss. The income from the sale of energy is essentially a by-product of the development and is not necessary to develop the assets for their intended use. Therefore the income should be shown as operating income. There are differing views on whether offsetting provides decision useful information and is appropriate under the *Conceptual Framework*. It is felt that offsetting is not in line with the *Conceptual Framework* and in this case is not appropriate due to the different nature of the income from the expense items.

#### 4 (a) (i) Importance of information concerning an entity's capital

Essentially there are two classes of capital reported in financial statements, namely debt and equity. However, debt and equity instruments can have different levels of right, benefit and risks. Hence, the details underlying a company's capital structure are absolutely essential to assessing the prospects for changes in a company's financial flexibility, and ultimately, its value.

For investors who are assessing the risk profile of an entity, the management and level of an entity's capital is an important consideration. Disclosures about capital are normally in addition to disclosures required by regulators as their reasons for disclosure may differ from those of the International Accounting Standards Board (IASB). The details underlying a company's capital structure are essential to the assessment of any potential change in an entity's financial standing.



Investors have specific but different needs for information about capital depending upon their approach to their investment in an entity. If their approach is income based, then shortage of capital may have an impact upon future dividends. If ROCE is used for comparing the performance of entities, then investors need to know the nature and quantity of the historical capital employed in the business. Some investors will focus on historical invested capital, others on accounting capital and others on market capitalisation.

### Published information

As an entity's capital does not relate solely to financial instruments, the IASB has included these disclosures in IAS 1 *Presentation of Financial Statements* rather than IFRS 7 *Financial Instruments: Disclosures*. Although IFRS 7 requires some specific disclosures about financial liabilities, it does not have similar requirements for equity instruments.

As a result, IAS 1 requires an entity to disclose information which enables users to evaluate the entity's objectives, policies and processes for managing capital. This objective is obtained by disclosing qualitative and quantitative data. The former should include narrative information such as what the company manages as capital, whether there are any external capital requirements and how those requirements are incorporated into the management of capital. The IASB decided that there should be disclosure of whether the entity has complied with any external capital requirements and, if not, the consequences of non-compliance.

Besides the requirements of IAS 1, the IFRS *Practice Statement, Management Commentary* suggests that management should include forward-looking information in the commentary when it is aware of trends, uncertainties or other factors which could affect the entity's capital resources. Additionally, some jurisdictions refer to capital disclosures as part of their legal requirements.

In addition to the annual report, an investor may find details of the entity's capital structure where the entity is involved in a transaction, such as a sale of bonds or equities. It can be seen that information regarding an entity's capital structure is spread across several documents including the management commentary, the notes to financial statements, interim financial statements and any document required by securities regulators.

### Integrated reporting

The capitals identified by the International Integrated Reporting Council (IIRC) are: financial capital, manufactured capital, intellectual capital, human capital, social and relationship capital, and natural capital. Together, they represent stores of value which are the basis of an organisation's value creation. Financial capital is broadly understood as the pool of funds available to an organisation. This includes both debt and equity finance. This description of financial capital focuses on the source of funds, rather than its application which results in the acquisition of manufactured or other forms of capital. Financial capital is a medium of exchange which releases its value through conversion into other forms of capital. It is the pool of funds which is available to the organisation for use in the production of goods or the provision of services obtained through financing, such as debt, equity or grants, or generated through operations or investments.

- (ii) Whether an instrument is classified as either a financial liability or as equity is important as it has a direct effect on an entity's reported results and financial position. The critical feature of a liability is that, under the terms of the instrument, the issuer is or can be required to deliver either cash or another financial asset to the holder and it cannot avoid this obligation. An instrument is classified as equity when it represents a residual interest in the issuer's assets after deducting all its liabilities. If the financial instrument provides the entity an unconditional discretion, the financial instrument is equity.

IAS 32 *Financial Instruments Presentation* sets out the nature of the classification process but the standard is principle based and sometimes the outcomes are surprising to users. IAS 32 focuses on the contractual obligations of the instrument and considers the substance of the contractual rights and obligations. The variety of instruments issued by entities makes this classification difficult with the application of the principles occasionally resulting in instruments which seem like equity being accounted for as liabilities. Recent developments in the types of financial instruments issued have added more complexity to capital structures with the resultant difficulties in interpretation and understanding.

Equity and liabilities are classified separately in the statement of financial position. The *Conceptual Framework* distinguishes the two elements by the obligation of the entity to deliver cash or other economic resources from items which create no such obligation. The statement of profit or loss and other comprehensive income (OCI) includes income and expenses arising from liabilities which is interest and, if applicable, remeasurement and gain or loss on settlement. The statement does not report as income or expense any changes in the carrying amount of the entity's own equity instruments but does include expenses arising from the consumption of services which fall under IFRS 2 *Share-based Payment*. IFRS 2 requires a valuation of the services consumed in exchange for the financial liabilities or equity instruments.

In the statement of financial position, the carrying amount of many financial liabilities changes either with the passage of time or if the liability is remeasured at fair value. However, the amount reported for classes of equity instruments generally does not change after initial recognition except for non-controlling interest.

Liability classification typically results in any payments on the instrument being treated as interest and charged to earnings. This may in turn affect the entity's ability to pay dividends on its equity shares depending upon local legislation.

Equity classification avoids the negative impact which liability classification has on reported earnings, gearing ratios and debt covenants. It also results in the instrument falling outside the scope of IFRS 9 *Financial Instruments*, thereby avoiding the complicated ongoing measurement requirements of that standard.

- (b) In the case of the first class of preference shares, even though there are negative consequences of not paying dividends on the preferred shares as agreed contractually, the company can avoid the obligation to deliver cash. The preferred shares do have redemption provisions but these are not mandatory and are at the sole discretion of the management committee and therefore the shares should be classified as equity.

In the case of the second class, the contractual term requires no dividend to be paid to ordinary shareholders if a payment is not made on the preferred shares. In this case, as Amster can avoid the obligation to settle the annual dividend, the shares are classified as equity. Thus \$75 million should be transferred from liabilities to equity.

IFRS 2 *Share-based Payment* states that cash settled share-based payment transactions occur where goods or services are paid for at amounts which are based on the price of the company's equity instruments. The expense for cash settled transactions is the cash paid by the company and any amounts accrued should be shown as liabilities and not equity. Therefore Amster should remove the following amount from equity and show it as a liability.

Expense for year to 30 November 2017 is:

$$((1,500 - 180 \text{ employees} \times 250 \text{ awards} \times \$35) \times 1/3 = \$3.85 \text{ million})$$

As a result of the adjustments to the financial statements, Amster's gearing ratio will be lowered significantly as the liabilities will drop from 53.8% of total capitalisation to 33.2% of total capitalisation. However, the ROCE may stay the same even though there is an increase in shareholders equity as total capitalisation has not changed. However, this will depend upon the definition used by the entity for capital employed.

#### Amster Group – capitalisation table

	30 November 2017 (\$ million)	Adjustment (\$m)	30 November 2017 (\$ million)
Long-term liabilities	81	3.85	84.85
Pension plan deficit	30		30
Cumulative preference shares	75	(75)	–
Liabilities	<u>186</u>		<u>114.85</u>
Non-controlling interest	10		10
Shareholders equity	150	(75 – 3.85)	<u>221.15</u>
Group equity	<u>160</u>		<u>231.15</u>
Total capitalisation	<u>346</u>		<u>346</u>

	<i>Marks</i>
<b>1 (a)</b> Lyndhurst – legal fee	1
Lyndhurst – step acquisition	2
Lyndhurst – goodwill and impairment	3
Tybull – intra group and PURP	4
Tybull – fair value adjustment	2
Translation at average rate	1
Tybull goodwill and impairment	4
Exchange differences	4
Revaluation and deferred tax	4
Pension	4
NCI calculations	2
Other comprehensive income parent	3
SOPL presentation	1
	<hr style="width: 100%; border: 0.5px solid black;"/>
	35
<b>(b)</b> 1 mark per sensible point	8
<b>(c)</b> 1 mark per sensible point. Maximum of 4 marks per rationale intra group transactions and max of 4 marks per ethics	Maximum 7
	<hr style="width: 100%; border: 0.5px solid black;"/>
	<b>50</b>
<b>2 (a)</b> 1 mark per point up to maximum	8
<b>(b)</b> 1 mark per point up to maximum	7
<b>(c)</b> 1 mark per point up to maximum	8
Professional marks	2
	<hr style="width: 100%; border: 0.5px solid black;"/>
	<b>25</b>
<b>3 (a)</b> 1 mark per point up to maximum	8
<b>(b)</b> 1 mark per point up to maximum	7
<b>(c)</b> 1 mark per point up to maximum	8
Professional marks	2
	<hr style="width: 100%; border: 0.5px solid black;"/>
	<b>25</b>
<b>4 (a) (i)</b> 1 mark per point up to maximum	8
<b>(ii)</b> 1 mark per point up to maximum	6
<b>(b)</b> 1 mark per point up to maximum	9
Professional marks	2
	<hr style="width: 100%; border: 0.5px solid black;"/>
	<b>25</b>