

SECTION A

QUESTION 1.

Luna Co is the parent company of a group that operates in the pharmaceutical industry. All entities in the group have a financial year end of 31 March. The current year end is 31 March 20X6.

The following **exhibits**, available on the left-hand side of the screen, provide information relevant to the question:

1. Sale of shares in Starlight Co – provides information regarding a disposal of shares by Luna Co in Starlight Co during the year ended 31 March 20X6.
2. Sale of goods to Starlight Co – provides information regarding a sale of goods between Luna Co and Starlight Co shortly before the reporting date.
3. Roquet Co – provides information about the creation of Roquet Co including details of a sale of property from Luna Co to Roquet Co.
4. Eclip Co – provides information about the acquisition of Eclip Co.

EXHIBIT 1. Sale of shares in Starlight Co

Luna Co acquired its 80% equity interest in Starlight Co on 1 April 20X2. Starlight Co had in issue 1,000,000 (\$1) equity shares and has not issued any shares for many years. Goodwill on acquisition was correctly calculated as \$320,000 but had subsequently been impaired by 15% in 20X4. Luna Co values the non-controlling interest at fair value. The fair value of the net assets of Starlight Co at acquisition exceeded their carrying amount by \$200,000. This all related to non-depreciable land which is still owned by Starlight Co at 31 March 20X6.

On 1 January 20X6, Luna Co sold 100,000 equity shares in Starlight Co for \$7 a share. The only reserve within equity in the individual statement of financial position of Starlight Co is retained earnings. The balance of this reserve at 1 April 20X5 was \$4,658,000. Starlight Co generated a profit for the year ended 31 March 20X6 of \$165,056 which accrued evenly throughout the year.

EXHIBIT 2. Sale of goods to Starlight Co

On 20 March 20X6, Luna Co sold 5,000 units to Starlight Co at an initial transaction price of \$200 per unit and control of the goods passed from Luna Co to Starlight Co on that date. Payment is only due when Starlight Co sells the goods on to the end consumer which typically takes around six months. Starlight Co had not yet sold any goods on to the final consumer as at 31 March 20X6.

The goods have a high risk of obsolescence and therefore price concessions are regularly granted in order that the goods can be easily transferred on within the distribution channel. On the basis of past practice, Luna Co anticipates that it will grant Starlight Co a price concession of between 8% and 38%. Current market data suggests that a maximum price concession of 35% may be necessary to enable Starlight Co to distribute the goods to the final consumer.

The initial cost of the goods to Luna Co was \$80 per unit. Luna Co has recorded the sale at the initial transaction price of \$200 per unit. Starlight Co has included the goods within their closing inventory at a value of \$1,000,000. Revenue and cost of sales for the respective entities for the year ended 31 March 20X6 are as follows:

	Luna Co	Starlight Co
	\$	\$
Revenue	29,812,540	14,185,160
Cost of sales	(18,154,020)	(11,042,120)

EXHIBIT 3. Roquet Co

On 1 April 20X4, Luna Co and an unconnected third party established a joint arrangement involving the creation of a joint venture, Roquet Co. Each venturer paid \$6 million in cash to the newly created entity, Roquet Co, in exchange for a 50% interest in the equity shares.

Roquet Co has earned profits for the year of \$73,450 and \$126,980 in the years ended 31 March 20X5 and 31 March 20X6 respectively. Additionally, Roquet Co paid dividends to both Luna Co and the other venturer of \$15,000 each in the current year. This was the first time Roquet Co had paid dividends to its investors.

On 31 March 20X6, Luna Co transferred a property to Roquet Co for proceeds of \$8 million which is agreed to be equal to the market value of the property on that date. The carrying amount of the property in the financial statements of Luna Co at this date was \$10 million.

EXHIBIT 4. Eclip Co

Eclip Co is an entity which has a sole purpose of producing a new medicine to fight various diseases, having secured a licence to do so following successful initial trials. Eclip Co's employees consist of a highly skilled team of scientists. There is also a small support team under contract who carry out various administrative and accounting functions. Clinical tests undertaken by the team of scientists have been extremely encouraging and it is expected that the medicine will be on the market sometime within the next year.

On 31 March 20X6, Luna Co acquired 100% of Eclip Co. It was also decided that it would be important to retain the contracts of the team of scientists (although not the administrative employees) as there was considerable specialised knowledge and experience within the team. The only assets recognised in the individual financial statements of Eclip Co at 31 March 20X6 consisted of the licence to manufacture the medicine and related development costs. However, Luna Co estimated it was worth paying an extra \$1.5 million in consideration in order to secure the skills and experience of the team of scientists.

REQUIREMENTS (30 MARKS)

(a)(i) Explain, with calculations, how the disposal of shares in Starlight Co should be accounted for in the consolidated financial statements of the Luna group for the year ended 31 March 20X6.

(7 marks)

(a)(ii) Discuss the principles that should be considered by Luna Co in recording the sale of the goods to Starlight Co in Luna Co's INDIVIDUAL financial statements for the year ended 31 March 20X6. Conclude on whether the accounting treatment currently adopted is correct.

(6 marks)

(a)(iii) Using exhibits 1 and 2 only, present extracts that should be included in the consolidated statement of profit or loss of the Luna group for the year ended 31 March 20X6. Your answer should include revenue, cost of sales and the profit of Starlight attributable to the non-controlling interest.

(4 marks)

(b) Discuss, with calculations, how the investment in Roquet Co and the sale of the property should be accounted for in the consolidated financial statements of the Luna group in the year ended 31 March 20X6.

(7 marks)

(c) Discuss whether the acquisition of Eclip Co should be treated as a business combination in accordance with IFRS 3 *Business Combinations*. Your answer should consider whether the skills and experience of the team of scientists can be recognised as a separate identifiable asset.

(6 marks)

QUESTION 2.

Renshu Co develops gaming apps for which customers are encouraged to buy enhancements and add-ons to play more effectively. The company's current financial year end is 31 December 20X8.

The following **exhibits**, available on the left-hand side of the screen, provide information relevant to the question:

1. Loans to customers - describes the ethical issues related to authorising loans to customers.
2. Acquisition of assets - sets out the accounting for the acquisition of intangible assets that do not constitute a business.
3. Payments for the app - describes the accounting for and derecognition of intangible assets.

EXHIBIT 1. Loans to customers

The financial accountant of Renshu Co, an ACCA member, is responsible for overseeing the authorisation of small loans of up to \$500 to customers for use on their gaming app, Jammy Play. He is paid a commission based upon the number of loans granted in a period. The effective interest rate on the loan is approximately 1076% per annum. However, if the loan is paid back within one month, there is no interest charged. Customers apply for short-term loans via an online portal which gives them an instant decision as to whether the loan is approved. Artificial intelligence (AI) systems, which have been subject to frequent cyberattacks, are used in this process. Currently, the laws on consumer credit in the jurisdiction only allow such loans where the credit worthiness of the applicant has been checked.

There are two groups of customers (group A and B) who have different social demographics. The financial accountant has full knowledge of the AI system and knows that the credit approval system is positively biased in the favour of group A. He defends this practice by saying that it gives group A a chance to improve their financial position. Group A is known to have less wealth than group B and is less likely to be able to afford to pay back the loan within a month.

EXHIBIT 2. Acquisition of assets

Renshu Co has purchased a company which comprised a customer database and a number of domain names which do not constitute a business. Therefore Renshu Co has to allocate the purchase price to the individual identifiable assets in accordance with IFRS 3 *Business Combinations*.

The customer database relates to a contractual arrangement whereby Renshu Co receives a commission for referring customers to online gaming websites. Renshu Co either receives an up-front payment for every customer referred to the gaming websites or it receives a share of revenue streams based on the referred customer's further usage.

The acquired assets also included a number of domain names for websites which have gaming content.

Renshu Co had arbitrarily allocated the purchase price for the company to the two intangible assets, domain names and customer databases, on a 50:50 basis.

EXHIBIT 3. Payments for the app

Renshu Co develops new gaming apps in conjunction with other companies. When acquiring a stake in these projects, Renshu Co makes an up-front payment and agrees a series of further payments based upon the fulfilment of certain defined objectives in the process, both before and after the app is given final government approval.

Prior to the current year, the payments made have been accounted for as an acquisition of separate intangible assets as the price paid reflected its belief that expected future economic benefits would flow to Renshu Co. The probability recognition criterion in IAS 38 *Intangible Assets* was considered to be met.

However, in the year to 31 December 20X8, Renshu Co revised its strategic plan and decided that all previously capitalised payments to date were to be derecognised and expensed as research and development costs. This reversal of the current accounting treatment has arisen due to concerns that the payments did not meet the criteria for recognition as intangible assets and also that the costs will not be recovered in full. Renshu Co considered this action to be a change in an accounting estimate and, therefore, recognised the amounts prospectively by recharging the payments to profit or loss.

REQUIREMENTS (20 MARKS)

(a) Discuss the ethical and professional dilemmas for the financial accountant in overseeing the loans made to customers and the appropriate actions to be taken.

(8 marks)

Professional marks will be awarded in part (a) for the quality of the discussion.

(2 marks)

(b) Discuss whether the customer databases and domain names should be recognised under IAS 38 *Intangible Assets* and how the purchase price should have been allocated in accordance with IFRS 3 *Business Combinations*.

(4 marks)

(c) Advise Renshu Co on the accounting treatment of the payments for the app in the year ended 31 December 20X8 on the assumptions that the amounts:

- did meet the recognition criteria for an intangible asset; or
- did not meet the recognition criteria for an intangible asset.

(6 marks)

SECTION B

QUESTION 3.

Bohai Co trades as a leisure travel group and provides travellers with unique vacations. The financial year end of the company is 31 December 20X8.

The following **exhibits**, available on the left-hand side of the screen, provide information relevant to the question:

1. Impairment test - describes why the directors did not conduct an impairment test at 31 December 20X8.
2. Deferred tax asset - describes the accounting treatment of deferred tax assets at 1 January 20X8 and 31 December 20X8.
3. Operating leases - describes the lease and non-lease components of agreements with third parties.

EXHIBIT 1. Impairment test

Bohai Co has a portfolio of global cruise brands and a fleet of over 100 ships. At 31 December 20X8 as a result of a global recession, the directors of Bohai Co assessed whether there was any indication that its cruise ships may be impaired. The directors concluded that the ships should be measured at their carrying amount without conducting an impairment test. The directors had highlighted several factors which were pertinent to this conclusion.

- The price-to-book ratio, calculated by dividing the market price per share by the carrying amount of the net assets per share, was 0.3. The directors were happy with this ratio as it was similar to other companies in the industry.
- There had been no losses from the disposal of surplus ships in 20X8 which were material in respect of the 20X8 year end financial statements.
- There had only been an estimated 2% drop in the market value of the fleet in December 20X8. The directors had not engaged a qualified valuer to estimate the market value of the fleet and this value was not based upon market transactions.
- The cost of fuel for the ships had fallen and there was an increase in demand for cruising after a significant reduction due to a recession.
- Bohai Co has started negotiations with its creditors to defer payments of its debt into 20X9.

Bohai Co had ignored the fact that several companies in the industry had written down the carrying amount of their ships during 20X8. This was as a result of many ships, including Bohai Co's ships, lying idle as a result of overcapacity due to the recession. Even though the losses from the total sale of ships in Bohai Co were not material in the financial statements for the year ended 31 December 20X8, there were several cases where the loss relating to the disposal of a ship was 40% of the carrying amount of the ship.

The price of a cruise had not increased in two years and therefore conservative income estimates had been applied in future budgets because of an anticipated delay in the recovery of the cruise market.

EXHIBIT 2. Deferred tax asset

Bohai Co applied the expected credit loss (ECL) model in accordance with IFRS 9 *Financial Instruments* for the first time at 1 January 20X8. As a result, the ECL model had a negative impact on the opening retained earnings as Bohai Co correctly applied the impairment model retrospectively. Therefore, a deferred tax asset (DTA) was recognised of \$25 million because of increased tax losses. The recoverability of the DTA was based upon future budgets.

As at 31 December 20X8, there was a change in the ECL allowance. As a result, Bohai Co increased the amount of DTAs assessed as recoverable from \$25 million to \$30 million and recognised the increase in DTAs of \$5 million in profit or loss.

Bohai Co has a subsidiary, Yuyan Co, which has a deferred tax liability of \$10 million. Bohai Co has a legally enforceable right to offset its own tax assets and liabilities but not that of its subsidiary. The directors of Bohai Co have decided that, as Yuyan Co is located within the same taxation jurisdiction as Bohai Co, they can offset the deferred tax asset of \$30 million against Yuyan Co's deferred tax liability of \$10 million.

EXHIBIT 3. Operating leases

The business model of Bohai Co also includes the management and refurbishment of cruise ships. Income is generated by:

- (I) leasing cruise ships on operating leases to third parties, normally for a period of five years; and
- (II) managing the cruise ships operations (non-lease element).

Gross revenue therefore comprises rental income and recharges of operating fees. Bohai Co bears all costs which occur when the lessee operates the cruise ships and recharges them to the lessee.

For some operational items such as fuel and food supplies, the lessee can enter into direct purchase agreements with third parties at each port but the third parties bill Bohai Co directly as Bohai Co arranges the port facility. In this specific case, Bohai Co then recharges the costs to the lessee based on the lessee's consumption of goods plus a management fee.

For other operating costs of the cruise ship such as engine maintenance and cleaning of the cruise ship, these are billed at a price agreed on the date when the lease is signed.

Bohai Co concluded that it acts as a principal in all of its dealings with the lessee and recorded all revenue gross.

REQUIREMENTS (25 MARKS)

(a) Discuss whether the directors of Bohai Co were correct in not conducting an impairment test at 31 December 20X8.

(9 marks)

(b) In accordance with IAS 12 *Income Taxes*, discuss:

- whether it is acceptable for Bohai Co to recognise the additional deferred tax asset of \$5 million in profit or loss rather than equity at 31 December 20X8; and
- whether the deferred tax liability of Yuyan Co of \$10 million can be offset against the deferred tax asset of \$30 million of Bohai Co at the same date.

(7 marks)

(c) Explain how Bohai Co should account for the lease and non-lease components of the cruise ship agreements in accordance with IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases*.

(9 marks)

QUESTION 4.

Wing Co manufactures textile products and is currently assessing the impact of a global pandemic on its operations. The financial year end of the company is 31 December 20X8.

The following **exhibit**, available on the left-hand side of the screen, provides information relevant to the question:

1. Impact of pandemic - describes the impact of the pandemic on certain aspects of Wing Co's business

EXHIBIT 1. Impact of pandemic

There are several measures taken by government and banks in the jurisdiction which Wing Co operates in to provide relief for companies which have been negatively affected by the pandemic. The business reduction loan scheme provides lenders with a government guarantee of 90% on each loan to give lenders confidence in continuing to provide finance to companies. The national bank is also buying short-term debt from companies.

Wing Co has a history of profitable operations and relies on external financing resources. Wing Co has taken advantage of the government support measures. However, its operations have been temporarily suspended before and after the reporting date of 31 December 20X8. The impact of the pandemic has created circumstances which change rapidly.

The pandemic has significantly affected the global supply chain. Wing Co has several contracts to sell goods at a fixed price. Because of the shutdown of its manufacturing facilities, as required by the government, it cannot deliver the goods itself without first buying them from a third party at a significantly higher cost. Normally if Wing Co terminates the contracts, then it incurs a penalty. Exceptionally, some contracts can be cancelled without paying compensation.

Wing Co has several investment properties which it measures at fair value in accordance with IFRS 13 *Fair Value Measurement*. The pandemic has significantly affected the market price of these properties.

The directors of Wing Co are of the opinion that the market is undervaluing its properties and have therefore decided to disregard market prices at 31 December 20X8. The directors claim that some of the market transactions are not representative as they are based on transactions which are forced due to the cash flow problems of the vendors. The directors have indicated that they would not sell their properties in the current market. There has been a significant decrease in the volume of transactions in the property market. However, several properties, similar to those held by Wing Co, have been sold in December 20X8.

REQUIREMENTS (25 MARKS)

(a) With regards to Wing Co's financial statements for the year ended 31 December 20X8, discuss the impact that the pandemic and subsequent events will have on:

(i) the assessment regarding Wing Co's ability to remain a 'going concern';

(5 marks)

(ii) accounting for onerous contracts; and

(4 marks)

(iii) fair value measurement of investment property.

(6 marks)

(b) Discuss the nature of the information that investors of Wing Co will expect to be disclosed in financial statements as a result of the pandemic. Candidates should include amongst other things such factors as disclosure of uncertainties, events after the reporting period, government measures and covenants.

(8 marks)

Professional marks will be awarded in part (b) for clarity and quality of discussion.

(2 marks)