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STRATEGIC BUSINESS REPORTING (SBR)

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1 Section A Questions – Group Financial Statements

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KABELO (SEP/DEC 2023)

BACKGROUND

Kabelo Co is the parent company of a group whose financial year end is 31 December 20X5. The following **exhibits** provide information relevant to the question:

1. Acquisition of Trudos Co – provides information regarding the acquisition of Trudos Co and other information relevant to complete the consolidated statement of cash flows.
2. Financial instruments – contains information about a number of financial instruments held by the Kabelo Group.
3. Consolidated statements – this includes the draft extracts for the consolidated statement of cash flows together with extracts from the finalised consolidated statement of financial position for the year ended 31 December 20X5 including comparative figures.

This information should be used to answer the question **requirements** within your chosen response option(s).

1. ACQUISITION OF TRUDOS

- Kabelo Co acquired 80% of the 100,000 equity shares of Trudos Co on 30 June 20X5. The consideration consisted of a cash payment of $5 per share acquired and an issue of one Kabelo Co $1 equity share for every four shares acquired in Trudos Co. Kabelo Co's policy is to value non-controlling interest at fair value at the date of acquisition. The fair value of Kabelo Co's and Trudos Co's shares on 30 June 20X5 were $13 and $8 respectively.

The carrying amount of the net assets reported by Trudos Co on 30 June 20X5 were as follows:

	$
Property, plant and equipment	421,000
Inventories	256,800
Trade receivables	220,300
Cash and cash equivalents	24,900
Trade payables	(175,400)
	747,600

The only fair value adjustment on acquisition related to plant which had a fair value of

$50,000 above its carrying amount.

The group pays tax at 30% and deferred tax was correctly accounted for within the consolidated statement of financial position. The taxation figure in the statement of profit or loss for the year ended 31 December 20X5 is $385,600 and this figure has been included as taxation paid within the draft statement of cash flows.

The group's financial controller has accurately completed the consolidated statement of financial position and consolidated statement of profit or loss and other comprehensive income but the consolidated statement of cash flow is in draft. The financial controller has not yet considered the impact of the acquisition of Trudos Co on the consolidated statement of cash flow.

The statement of cash flows figures for movements in inventories, trade receivables, trade payables and property, plant and equipment have been calculated by considering simply the differences in the year-end balances in the consolidated statement of financial position from 31 December 20X4 and 31 December 20X5.

Goodwill of Trudos Co was impaired during the year. There were no other goodwill impairments within the group.

The depreciation charge of the group for the year ended 31 December 20X5 was $625,060.

There were no disposals of non-current assets by the group during the year although there were some additions paid for by cash.

2. FINANCIAL INSTRUMENTS

- The Kabelo Group has a number of financial instruments presented within its consolidated statement of financial position. Some group entities which had surplus cash resources had acquired debentures in other non-group entities to increase returns. Other group entities had raised finance by issuing bonds.
- Kabelo Co financed the acquisition of Trudos Co by acquiring a bank loan.
- Kabelo Co also had an overdrawn bank balance as at 31 December 20X5. The overdrawn bank balance fluctuates regularly from an in-funds balance to an overdrawn balance.

3. CONSOLIDATED STATEMENTS

- The extracts below would have been replicated in the pre-populated spreadsheet response option.

Draft extracts from the consolidated statement of cash flows for the Kabelo Group for the year ended 31 December 20X5:

Cash inflow from operating activities:	**$**
Profit before taxation	1,318,100
Depreciation	625,060
Increase in inventories	(658,100)
Increase in trade and other receivables	(211,500)
Increase in trade and other payables	93,900
Cash generated from operations	**1,167,460**
Taxation paid	(385,600)
Cash inflow from operating activities	**781,860**
Cash-flow from investing activities Acquisition of property, plant and equipment	(543,600)
Consideration paid for acquisition of Trudos Co	(not yet calculated)
Cash outflow from investing activities	(543,600)

Extracts from the consolidated statement of financial position of the Kabelo Group:

	31 December 20X5 **$**	**31 December 20X4** **$**
Property, plant and equipment	3,668,900	3,125,300
Goodwill	447,400	441,100
Deferred tax liability	130,000	250,000
Current tax liability	364,300	256,900

Required:

(a) Using exhibit 1,

(i) adjust the pre-populated spreadsheet to prepare revised extracts for the operating and investing activities of the consolidated statement of cash flows for the Kabelo Group for the year ended 31 December 20X5, and

(14 marks)

(ii) explain the adjustments required to correct the operating and investing activities of the consolidated statement of cash flows for the Kabelo Group for the year ended 31 December 20X5. **(10 marks)**

(b) Using exhibit 2,

Advise the financial controller as to how the various financial instruments, including the overdraft, should be presented in the consolidated statement of cash flows. **(6 marks)**

(Total: 30 marks)

GREER (MAR/JUN 2023)

BACKGROUND

Greer Co is a listed parent company of a manufacturing group. Greer Co is preparing the group financial statements for the year ended 31 December 20X7.

The following exhibits provide information relevant to the question:

1. Acquisition of Layout Co – describes a business combination.
2. Goodwill on acquisition of Layout Co – describes the values attributed to the calculation of goodwill on the business combination with Layout Co.
3. Investment in Gae Co – describes an additional investment in the year.
4. Loan agreement – describes the terms of a bank loan agreement.

This information should be used to answer the question requirements within your chosen response option(s).

1. ACQUISITION OF LAYOUT

- Greer Co whose shares are listed on a stock exchange and Layout Co, an unlisted company, entered into a business combination in two stages. On 1 January 20X7, Greer Co purchased 35% of the share capital and voting rights of Layout Co for cash. On 1 April 20X7, Greer Co acquired the remaining 65% of the share capital by issuing new shares to Layout Co's shareholders.
- On 1 April 20X7, Greer Co had a market value of $70 million and Layout Co had a value of $90 million. Greer Co's business represents 44% and Layout Co's business 56% of the total value of the combined businesses. After 1 April 20X7, the former shareholders of Greer Co owned 51% and the former shareholders of Layout Co owned 49% of the voting rights of the combined entity.
- On 1 April 20X7, the purchase agreement provided for a new board of directors of the combined entity comprising six board members of Greer Co and two board members of Layout Co. The CEO of Layout Co is the CEO of the combined entity. The board of directors nominates the members of the management team but the CEO has significant influence over the selection of the team. The management team comprises the CEO and five other members, three from Greer Co and two from Layout Co.

2. GOODWILL ON ACQUISITION OF LAYOUT

- On 1 January 20X7, Greer Co paid $34 million cash for 35% of the share capital of Layout Co.
- On 1 April 20X7, Greer Co issued 25 million shares of $1 to Layout Co's shareholders in order to acquire the remaining 65% of the share capital. The shares of Greer Co were quoted on the stock exchange at $2.85 on 1 April 20X7.
- On 1 April 20X7, Greer Co had a market value of $70 million and Layout Co had a value of $90 million. Greer Co had treated its 35% holding as an associate and its carrying amount on 1 April 20X7 was $36 million. The fair value of the identifiable net assets of Layout Co was $87 million on 1 April 20X7.

3. INVESTMENT IN GAE CO

- Greer Co acquired a 10% interest in Gae Co, a listed company, on 1 January 20X7 for $23 million. Greer Co elected at initial recognition to measure it at fair value through other comprehensive income (FVTOCI) as the investment was not held for trading.
- On 1 July 20X7, Greer Co acquired an additional 12% interest in Gae Co for $30 million and achieved significant influence. On 1 July 20X7, the fair value of a 10% interest in Gae Co was
- $26 million. Gae Co made profits of $20 million before dividends for the year to 31 December 20X7. Greer Co received a dividend of $0.2 million on 31 March 20X7. This was the only dividend paid in the year. Greer Co uses fair value as the 'deemed cost approach' in its financial statements.

4. LOAN AGREEMENT

- Greer Co took out a $27 million bank loan on 1 January 20X6, repayable after five years. Interest is charged at 5% per annum, payable annually on 31 December. Transaction costs of
- $675,000 were paid on 1 January 20X6. The effective interest rate was calculated as 5.6%. Greer Co has negotiated a change to the terms of its loan on 31 December 20X7 at no cost. This has resulted in the waiver of the interest payment due on that date with all other contractual cash flows remaining payable. The modification to the financial terms of the original bank loan is not considered substantive. The present value of the modified contractual cash flows at the original effective interest rate is $26,841,000.

Required:

(*a*) Using exhibit 1, evaluate the reasons why Greer Co, rather than Layout Co, can be identified as the acquirer in the business combination. **(10 marks)**

(*b*) Using exhibit 2, explain, with calculations, how the goodwill on the acquisition of Layout Co on 1 April 20X7 will be determined within the consolidated financial statements of the Greer Group for the year ended 31 December 20X7. **(5 marks)**

(*c*) Using exhibit 3, explain, with calculations, how the Greer Group would account for the investment in Gae Co in the consolidated financial statements for the year ended 31 December 20X7. **(9 marks)**

(*d*) Using exhibit 4, calculate and briefly outline, in accordance with IFRS 9 Financial Instruments, how the loan would be accounted for during the period 1 January 20X6 to 31 December 20X7. **(6 marks)**

(Total: 30 marks)

STERLING (SEP/DEC 2022)

BACKGROUND

Sterling Co is currently preparing its individual and consolidated financial statements for the year ended 31 March 20X9 in accordance with International Financial Reporting Standards.

The following exhibits, available below, provide information relevant to the question:

1. Acquisition of Berthold Co – describes the purchase of 40% of Berthold Co on 1 January 20X7 and the further acquisition of 35% on 1 December 20X8.
2. Investment in Malting Co – describes the purchase of 30% of Malting Co on 1 July 20X8.
3. Batch Co: discontinued operation – describes the acquisition of Batch Co that Sterling Co decides to sell on 1 January 20X9.

This information should be used to answer the question requirements within your chosen response option(s).

1. ACQUISITION OF BERTHOLD CO

- Sterling Co paid $25 million for 40% of Berthold Co's 10 million $1 ordinary shares on 1 January 20X7 when Berthold Co's retained earnings were $18 million. Berthold Co has no other reserves. Sterling Co exercised significant influence over Berthold Co's financial and operating policy decisions.
- A further 35% stake in Berthold Co was acquired on 1 December 20X8 for $41 million, when the fair value of Berthold Co's identifiable assets and liabilities was $55.3 million, and Berthold Co's retained earnings were $42.3 million. The difference between the fair value of the identifiable assets and liabilities of Berthold Co and their carrying amounts related to non-depreciable land. The market price of Berthold Co's shares immediately prior to 1 December 20X8 was $9.20 per share. Sterling Co measures non-controlling interest at fair value at the date of acquisition. Goodwill at 31 March 20X9 is not impaired.
- Berthold Co reported a profit for the year ended 31 March 20X9 of $11.1 million.

2. INVESTMENT IN MALTING CO

- On 1 July 20X8, Sterling Co paid cash of $2.5 million and issued loan notes with a nominal value of $1.1 million and a fair value of $1.3 million, to acquire 30% of the equity interest of Malting Co. The remaining 70% of the equity in Malting Co is owned equally between two unrelated companies. All key operating decisions require unanimous consent of all three investing parties. Each of the three investing parties has the right to its share of the net assets of Malting Co via a contractual agreement. Malting Co reported a loss of $0.8m for the year ending 31 March 20X9 and a dividend was neither paid nor proposed. All three investing parties provided separate guarantees to Malting Co's bank because of Malting Co's poor performance in the year.

3. BATCH CO: DISCONTINUED OPERATION

- On 1 January 20X9, Sterling Co announced a plan to dispose of Batch Co, which operates in a significantly different business sector to the rest of the group.
- Sterling Co first acquired 70% of the equity shares in Batch Co on 1 January 20X7, for consideration of $3.1 million, when the fair value of the identifiable net assets acquired was $3.6 million. The ordinary share capital and retained earnings of Batch Co were $0.5 million and $2.1 million respectively. The excess of the fair value of the identifiable net assets was due to a building with an estimated useful life of 10 years at the acquisition date. The fair value of the non-controlling interest (NCI) in Batch Co was $0.9 million on 1 January 20X7. Sterling Co uses fair values to measure NCI.
- On 1 January 20X9, Batch Co reported retained earnings of $2.9 million, with no change in ordinary share capital, or impairment of goodwill, since acquisition.
- Sterling Co decided to treat Batch Co as a disposal group held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. Assets and liabilities of Batch Co require no remeasurement to meet applicable IFRS standards prior to restating as a disposal group, and the total fair value less costs to sell of the disposal group at 1 January 20X9 was estimated to be $4.4 million.

Required:

(*a*) Using exhibit 1:

- explain how Berthold Co will be accounted for, including calculations, in Sterling Co's consolidated statement of profit or loss for the year ended 31 March 20X9, and **(8 marks)**
- Explain and show how the goodwill in Berthold Co would be calculated at 1 December 20X8. **(6 marks)**

(*b*) Using exhibit 2, advise the directors of Sterling Co, with illustrative calculations, how the 30% investment in Malting Co should be accounted for in Sterling Co's individual and consolidated financial statements. **(7 marks)**

(*c*) Using exhibit 3, explain to the directors of Sterling Co how to account for Batch Co as a discontinued operation at 1 January 20X9 in Sterling Co's consolidated financial statements. Your answer should include:

- a calculation of the goodwill at 1 January 20X7, and
- a calculation of how the investment in Batch Co should be measured prior to disposal. **(9 marks)**

(Total: 30 marks)

LUNA (MAR/JUN 2022)

BACKGROUND

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 below, 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.

This information should be used to answer the question requirements within your chosen response option(s).

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.

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)

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.

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 license 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 specialized knowledge and experience within the team. The only assets recognized in the individual financial statements of Eclip Co at 31 March 20X6 consisted of the license 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.

Required:

(*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)**

(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)**

(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 recognized as a separate identifiable asset. **(6 marks)**

(Total: 30 marks)

CHUCKLE (SEP/DEC 2021)

BACKGROUND

Chuckle Co has equity interests in several companies including Grin Co. The directors of Chuckle Co have prepared an incorrect spreadsheet of the consolidated statement of financial position at 1 April 20X6 (exhibit 4). All goodwill other than that relating to Grin Co has been impaired. The financial year end is 31 March each year.

The following exhibits, available below, provide information relevant to the question:

1. Initial acquisition of Grin Co – initial purchase of 30% of Grin Co on 1 April 20X4.
2. Subsequent acquisition of Grin Co – subsequent 18% purchase of Grin Co and the purchase of share options on 1 April 20X6.
3. Fair value of net assets of Grin Co – at 1 April 20X6.
4. Draft consolidated SOFP – Draft consolidated statement of financial position (SOFP) at 1 April 20X6.

This information should be used to answer the question requirements within your chosen response option(s).

1. INITIAL ACQUISITION OF GRIN CO

- On 1 April 20X4, Chuckle Co acquired 30% of the equity shares of Grin Co. The consideration consisted of $100 million cash. The carrying amount of the net assets of Grin Co on 1 April 20X4 was $286 million which was the same as the fair value. Since then, Grin Co has been stated at cost in the consolidated financial statements of Chuckle Co.
- The remaining 70% of the equity of Grin Co at 1 April 20X4 was owned by a few other investors, none of which owned more than 10% of the equity of Grin Co. Analysis shows that all shareholders have voted independently in the past. There has been no clear past voting pattern suggesting that Chuckle Co is unable to directly influence the economic decisions of the other investors. Chuckle Co and Grin Co share some key management personnel.
- The carrying amount of the net assets of Grin Co on 31 March 20X6 was $348 million. The increase in the net assets of Grin Co since acquisition was solely due to profits. Grin Co has paid no dividends since 1 April 20X4.

2. SUBSEQUENT ACQUISITION OF GRIN CO

- Chuckle Co acquired a further 18% of Grin Co's equity on 1 April 20X6.
- The remaining 52% of the equity of Grin Co at 1 April 20X6 is owned by a few other investors, none of which own more than 10% of the equity of Grin Co.

- On 1 April 20X6, Chuckle Co also acquired some share options in Grin Co exercisable any time until 31 March 20X7. The exercise price of the options at 1 April 20X6 was just above the market price of Grin Co's shares. Grin Co has been profitable for a number of years and the share price has been on an upwards trend which is expected to continue. Chuckle Co would increase its ownership to 60% should it exercise its rights. It is believed that there would be additional cost savings should the additional shares be acquired as decisions at board level could be made more efficiently.

3. FAIR VALUE OF NET ASSETS OF GRIN CO

- The directors of Chuckle Co have prepared a spreadsheet of the consolidated statement of financial position (SOFP) as at 1 April 20X6 (Exhibit 4). The investments in Grin Co have been stated at cost ($100 million and $66 million) and the net assets of Grin Co have been included at their carrying amounts. The equity of Grin Co has also been included as a balancing figure. Goodwill has not been calculated.
- The consideration for the further 18% of the equity shares of Grin Co on 1 April 20X6 is included in the SOFP at the cash amount of $66 million. The fair value of the original 30% equity interest was $127 million at 1 April 20X6.

The carrying amounts of the net assets of Grin Co on 1 April 20X6 were as follows:

	$m
Non-current assets	355
Current assets	214
Deferred tax liability	(16)
Current liabilities	(205)
Total	348

- Included within the non-current assets is some land. The carrying amount of this land at 1 April 20X6 is $50 million but its fair value is assessed to be $60 million at this date. Current assets include finished goods with a cost of $84 million. The fair value of these goods is $131 million.
- On 1 April 20X6, the directors of Chuckle Co also identified that Grin Co had an internally generated database of customers who were likely to be interested in purchasing their products. Although there were no contractual or legal rights associated with this database, a professional expert has estimated that competitors of Grin Co would be prepared to pay $5 million for this database. Grin Co has not recognized the database as an asset within the individual financial statements.

The current rate of tax is 20%. This rate should be applied to any fair value adjustments deemed necessary.

Chuckle Co measures the non-controlling interest as a proportionate share of the net assets at the date of acquisition.

4. DRAFT CONSOLIDATED SOFP

	$m
Assets Non-current assets	
Property, plant and equipment	2,021
Investment in associate	100
Further investment in associate	66
Goodwill	0
Other non-current assets	186
	2,373
Current assets	542
Total assets	2,915

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CONTENTS

1 IASB Conceptual Framework

LEARNING OBJECTIVES

1. Discuss the importance of the Conceptual Framework for Financial Reporting in underpinning the production of IFRS Accounting Standards.
2. Explain the objectives, principles, and limitations of financial reporting, including presentation and disclosure of information.
3. Evaluate the qualitative characteristics of useful financial information, including disclosure requirements.
4. Apply the principles of recognition, derecognition, and measurement, considering measurement uncertainty and materiality.
5. Critically analyze and apply the definitions of financial statement elements and their reporting in the statement of profit or loss and other comprehensive income (OCI).
6. Evaluate and apply fair value measurement principles, including the fair value hierarchy, valuation techniques, and concepts such as highest and best use, most advantageous, and principal market.

1. INTRODUCTION

The **Conceptual Framework for Financial Reporting** establishes foundational concepts for preparing and presenting financial statements for external users, as per the International Accounting Standards Board (IASB). It ensures consistency in **IFRS Accounting Standards** by guiding recognition, measurement, and presentation of transactions and events. Without it, standards could lack coherence, leading to inconsistencies.

Purpose:

- Assist IASB in developing IFRS standards based on consistent concepts.
- Help preparers establish accounting policies when no standard applies or when standards offer choices.
- Aid stakeholders in understanding and interpreting standards.

Status: The Conceptual Framework is not an IFRS standard and does not override specific IFRS requirements.

Chapters:

1. Objective of general purpose financial reporting
2. Qualitative characteristics of useful financial information
3. Financial statements and the reporting entity
4. Elements of financial statements
5. Recognition and derecognition
6. Measurement
7. Presentation and disclosure
8. Concepts of capital and capital maintenance

SBR Exam Relevance: The framework is critical for evaluating IFRS standards, discussing accounting treatments in scenarios, or advising on appropriate policies in the SBR exam.

2. OBJECTIVE OF GENERAL PURPOSE FINANCIAL REPORTING

The objective is to provide financial information useful to **primary users** (existing and potential investors, lenders, creditors) for decisions about providing resources to the entity. Users assess:

- **Future net cash inflows** (amount, timing, uncertainty).
- **Management's stewardship** of economic resources.

Information Needs:

- **Economic resources** (assets), **claims** (liabilities), and changes in these.
- **Financial position** (statement of financial position): Evaluates financial structure, liquidity, and solvency.
- **Financial performance** (statement of profit or loss and OCI): Reflects profitability via accrual accounting.
- **Cash flows** (statement of cash flows): Assesses cash generation and stewardship.

3. GOING CONCERN ASSUMPTION

Financial statements are prepared assuming the entity will continue operations for the foreseeable future without the need to liquidate or cease trading. If this assumption is in doubt, disclosures in the notes or a capital reconstruction may be required.

4. ELEMENTS OF FINANCIAL STATEMENTS

The framework adopts a **balance sheet approach**, defining five elements with assets and liabilities as the foundation, and income and expenses derived from changes in these.

4.1 ASSETS

Definition: A present economic resource controlled by the entity due to past events, with potential to produce economic benefits.

Key Elements:

- **Right**: May correspond to another party's obligation (e.g., receivables) or not (e.g., property, plant, and equipment).
- **Economic Benefits**: Future cash inflows, cost savings, or favorable exchanges. Low likelihood may affect recognition or measurement.
- **Control**: Ability to direct use and restrict others from benefiting.

Example: Purchased inventory is an asset; repair expenses are not.

4.2 LIABILITIES

Definition: A present obligation to transfer an economic resource due to past events, with no practical ability to avoid.

Key Elements:

- **Obligation**: Legal or constructive (e.g., per IAS 37 Provisions, Contingent Liabilities and Contingent Assets).
- **Transfer of Economic Resource**: No "probable" criterion; low likelihood affects recognition or measurement.
- **Past Event**: Obligation arises after receiving benefits or taking action.

4.3 OTHER ELEMENTS

- **Equity**: Residual interest in assets after deducting liabilities.
- **Income**: "increase" in assets or "decreases" in liabilities that increase equity (excluding equity contributions).
- **Expenses**: "decreases" in assets or "increase" in liabilities that decrease equity (excluding distributions).

4.4 Example 1: Elements of Financial Statements

Scenario: Orinoco signs a three-year contract with Sporting United, receiving a $100,000 signing bonus and a $40,000 monthly salary.

Question: Does the contract create an asset or liability for Sporting United?

Solution:

- **Asset**:
  - **Right**: Contractual right to Orinoco's playing services.
  - **Economic Benefits**: Potential ticket sales, sponsorships, despite risks (e.g., injury).
  - **Control**: Exclusive contract prevents other teams from using Orinoco.
  - **Conclusion**: Orinoco's services are an asset.
- **Liability**:
  - **Obligation**: Salary of $1.44M over three years.
  - **Past Event**: No benefits received at contract start; monthly services create a $40,000 liability per month.
  - **Conclusion**: No initial liability for full salary; recognize $40,000 monthly as services are rendered.

5. RECOGNITION AND DERECOGNITION

5.1 RECOGNITION

Definition: Capturing an item in financial statements that meets an element's definition and provides useful information.

Criteria:

- **Relevance**: Predictive or confirmatory value for users.
- **Faithful Representation**: Neutral, complete, free from error.
- **Measurement**: Acceptable level of uncertainty.

  Recognition may not occur if:
- uncertainty exists (e.g., uncertain asset/liability).
- Probability of economic benefits is low.
- Measurement uncertainty is too high (e.g., internally generated intangibles).

5.2 Example 2: Recognition

Scenario: Macdonald guarantees a $100,000 loan for its subsidiary, King, which is expected to service the debt.

Question: Should Macdonald recognize a liability?

Solution:

- **Liability Definition**: Guarantee is a present obligation (contractual) from a past event (agreeing to guarantee), with potential resource transfer if King defaults.
- **Recognition Criteria**: No indication of default; recognition unlikely to provide relevant information.
- **Conclusion**: Do not recognize a liability due to low probability of transfer.

5.3 Derecognition

Removal of an asset or liability from the statement of financial position when it no longer meets the element's definition, typically due to:

- Loss of control (assets).
- No present obligation (liabilities).

6. MEASUREMENT BASES

6.1 HISTORICAL COST VS. CURRENT VALUE

- **Historical Cost**: Transaction price at acquisition or incurrence; verifiable but less relevant over time (e.g., land, inventory).

- **Current Value**:
  - **Fair Value** (IFRS 13): Price to sell an asset or transfer a liability (e.g., financial assets).
  - **Value in Use/Fulfillment Value**: Present value of cash flows from "asset use" or "settlement of liability" (e.g., impaired assets).
  - **Current Cost**: Cost of an equivalent asset/liability today (e.g., replacement cost).

6.2 SELECTION CRITERIA

- **Relevance**: Current values are more relevant for market-sensitive items.
- **Faithful Representation**: Historical cost is verifiable; current values may involve measurement uncertainty.
- **Enhancing Characteristics**: Consider comparability, understandability, and consistency with related items.

7. PRESENTATION AND DISCLOSURE

Financial statements serve as communication tools, requiring:

- **Classification**: Grouping similar items, avoiding offsetting assets and liabilities.
- **Aggregation**: Balancing detail with clarity to avoid obscuring information.
- **Profit or Loss vs. OCI**: Income and expenses default to profit or loss unless an IFRS standard specifies OCI, with OCI typically reclassified ("recycled") to profit or loss later.

  Effective presentation enhances **relevance**, **faithful representation**, and **comparability**.

8. QUALITATIVE CHARACTERISTICS

8.1 FUNDAMENTAL CHARACTERISTICS

- **Relevance**: Aids decision-making with predictive (future events) and confirmatory (past evaluations) value. Affected by **materiality** (entity-specific, based on size or nature).
- **Faithful Representation**: Neutral, complete, free from error. Supported by **prudence** (cautious estimates, e.g., IFRS 9 expected credit losses, IAS 36 impairment).

8.2 ENHANCING CHARACTERISTICS

- **Comparability**: Enables trend analysis across time or entities, requiring consistent accounting policies (per IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors).
- **Verifiability**: Consensus on faithful representation via direct (e.g., inspection) or indirect (e.g., models) verification.
- **Timeliness**: Available for timely decision-making.
- **Understandability**: Clear for users with reasonable business and accounting knowledge.

8.3 MATERIALITY (IFRS PRACTICE STATEMENT 2)

Definition: Information is material if its omission, misstatement, or obscuring could influence primary users' decisions.

Four-Step Process (non-mandatory guidance):

1. Identify potentially material information (IFRS requirements, user needs).
2. Assess quantitative (size) and qualitative (nature) factors.
3. Organize information clearly in financial statements.
4. Review for completeness and aggregate impact.

Example 3: Materiality: A $4M property sale to a CEO-owned company is material due to its related-party nature (qualitative), regardless of monetary size.

8.4 COST CONSTRAINT

The cost of providing financial information should not exceed its benefits to users. Costs are borne by the entity (and ultimately users via lower returns), while benefits (e.g., improved decision-making, lower cost of capital) are harder to quantify. This constraint influences disclosure decisions to balance usefulness and practicality, ensuring financial statements remain cost-effective for preparers and users.

9. SUBSTANCE OVER FORM

Financial statements must reflect the **economic substance** of transactions, not just their legal form, to achieve faithful representation. This principle is critical to prevent misrepresentation and ensure a true and fair view.

9.1 Unethical Practices

Misapplication of IFRS standards to achieve desired outcomes is unethical and can lead to corporate failures, eroding "trust of investors" and triggering regulatory penalties. Examples include:

- **Off-Balance-Sheet Financing**: Excluding obligations from the statement of financial position (e.g., sale and repurchase misaccounted under IFRS 15 Revenue from Contracts with Customers), misleading users about debt levels and financial risk.
- **Profit Manipulation/Smoothing**: Early revenue recognition or incorrect provisions (e.g., per IAS 37) to stabilize profits. **Exhibit 1: Hollywood Accounting** in *Bohemian Rhapsody* allocated unrelated overheads to report a $51M loss despite $911M gross revenue, denying profit-sharing stakeholders (e.g., actors, screenwriters) their entitlements, damaging trust and credibility.
- **Balance Manipulation**: Temporary payable settlements or avoiding asset write-downs to improve ratios. **Exhibit 2: Ted Baker** overstated inventory by £58M (2019), ignoring net realizable value declines per IAS 2 Inventories, inflating profits, enabling unjustified dividends, and misleading investors about financial health, leading to scrutiny and reputational damage.

  SBR Relevance: These practices highlight the importance of ethical judgment in applying IFRS principles, a common exam theme.

10. ACCOUNTING THEORY VS. PRACTICE

IFRS standards are principle-based, requiring judgment, unlike rule-based US GAAP. This flexibility allows varied applications (e.g., IAS 16 Property, Plant and Equipment permits cost or revaluation models), leading to different valuations for identical items. Management may interpret transactions to achieve desired outcomes (e.g., highest profit, tax minimization), sometimes diverging from theory:

- **Examples**: Tesco's aggressive revenue recognition (supplier payments), Carillion's overstated construction contract revenue per IFRS 15, or hotel chains avoiding depreciation to boost profits, contrary to IAS 16.
- **Uncovered Areas**: Theory lags on emerging issues (e.g., cryptocurrencies, heritage assets like a Van Gogh painting) or seasonal trends (e.g., holiday revenue timing per IFRS 15).

  SBR Relevance: SBR candidates must evaluate such divergences, applying the Conceptual Framework to recommend appropriate treatments.

11. FAIR VALUE MEASUREMENT (IFRS 13)

11.1 DEFINITIONS

- **Fair Value**: Price to sell an asset or transfer a liability in an orderly transaction between market participants at the measurement date (exit price, market-based, not entity-specific).
- **Active Market**: Frequent transactions provide ongoing pricing.
- **Highest and Best Use**: Maximizes non-financial asset value (physically possible, legally allowed, financially feasible).
- **Principal Market**: Greatest transaction volume and activity.
- **Most Advantageous Market**: Maximizes asset value or minimizes liability after transaction and transport costs.

Key Points:

- IFRS 13 specifies *how* to measure fair value, not *when* (e.g., IAS 40 Investment Property permits fair value).
- Excludes IFRS 2 Share-based Payment's fair value definition.
- Fair value includes transport costs but excludes transaction costs.

11.2 VALUATION TECHNIQUES

- **Market Approach**: Use prices from identical or comparable assets/liabilities.
- **Cost Approach**: Reflects replacement cost (e.g., current cost).
- **Income Approach**: Discounts future cash flows (e.g., present value). Note: Option pricing models (e.g., Black-Scholes) are not examinable in SBR.

11.3 FAIR VALUE HIERARCHY

- **Level 1 Inputs**: Quoted prices for identical assets/liabilities in active markets (e.g., listed shares).
- **Level 2 Inputs**: Observable inputs for similar items, adjusted (e.g., comparable land prices).
- **Level 3 Inputs**: Unobservable inputs (e.g., estimated rental income), requiring entity assumptions.

11.4 Example 4: Principal and Most Advantageous Markets

Scenario: Jammie's asset has market prices of $120 (Europe) and $125 (Asia), with transaction costs ($5, $11) and transport costs ($5, $2).

Solution:

- **Principal Market (Europe)**: Fair value = $115 ($120 - $5 transport).
- **Most Advantageous Market (Asia)**: Net proceeds = $112 ($125 - $11 - $2); fair value = $123 ($125 - $2).
- **Liability**: Europe is most advantageous; fair value = $115 (lower settlement cost).

11.5 Example 5: Highest and Best Use

Scenario: GeoDee acquires a mining project but plans to halt it to block competitors.

Solution:

- **Market Participant Use**:
  - Continue development if it maximizes value (fair value based on sale assuming continued use with related assets).
  - Halt project if competitors have advanced technology (fair value based on locked-up sale).
  - Discontinue if no value (fair value may be zero).

11.6 Example 6: Fair Value Inputs

Scenario: Sutherland's assets:

1. Listed shares at quoted prices.
2. Land at adjusted comparable prices.
3. Investment properties using discounted rental income.

Solution:

- **Shares**: Level 1 (quoted prices in active market).
- **Land**: Level 2 (observable inputs, adjusted for attributes like size).
- **Properties**: Level 3 (unobservable inputs like vacancy rates, rental price increases).

11.7 Example 7: Fair Value of Liability

Scenario: Craddock owes $100,000 in two years; borrowing rate is 5%.

Solution:

- Fair value assumes transfer to a market participant, reflecting non-performance risk (credit rating).
- Fair value = $90,703 ($100,000 ÷ 1.05^2).

11.8 Activity 1: Investment Property

Scenario: Exeter's 420 sq.m investment property; comparable sales at $1,250, $1,255, $1,260, $1,270, $1,290 per sq.m.

Solution:

- (*a*) **Fair Value**:
  - **Mid-Value**: $529,200 (420 × $1,260). Alternative: $533,400 (420 × $1,270, accounting for wider spread above median).
  - **Average**: $531,300 (420 × $1,265, average of all prices).
- (*b*) **Alternatives**:
  - Exclude highest value ($1,290) for a lower average.
  - Use highest value if prices are trending upward.
  - Weighted average based on total sales prices and floor areas of comparable properties.

12. BENEFITS AND LIMITATIONS

12.1 BENEFITS

- Ensures consistency in IFRS standard development.
- Enhances transparency with fair value, reflecting current economic conditions.
- Eliminates impairment testing for fair-valued assets (e.g., per IAS 36).
- Enables recognition of assets/liabilities with negligible initial cost (e.g., derivatives).

12.2 LIMITATIONS

- Misalignment with older IFRS standards developed under previous frameworks.
- Fair value subjectivity reduces comparability (e.g., only some assets revalued).
- Complex measurements may confuse users, especially unrealized gains in profit.
- Over-reliance on fair value as a future predictor may mislead users.

13. CHAPTER SUMMARY

- **Purpose and Scope**: The Conceptual Framework underpins IFRS standards, guiding consistent recognition, measurement, and presentation, but does not override IFRS requirements.
- **Objective**: Provides useful financial information to primary users for resource allocation and stewardship, focusing on cash flows and economic resources.
- **Going Concern**: Assumes ongoing operations unless disclosed otherwise, critical for financial statement preparation.
- **Elements**: Defines assets, liabilities, equity, income, and expenses via a balance sheet approach, with examples like Orinoco's contract illustrating application.
- **Recognition/Derecognition**: Items recognized if relevant, faithfully represented, and measurable; derecognized when definitions are no longer met (e.g., Macdonald's guarantee).
- **Measurement**: Historical cost vs. current value (fair value, value in use, current cost), selected based on relevance and faithful representation.
- **Presentation/Disclosure**: Communicates via classification, aggregation, and profit or loss/OCI distinction, enhancing comparability.
- **Qualitative Characteristics**: Fundamental (relevance, faithful representation) and enhancing (comparability, verifiability, timeliness, understandability) ensure usefulness, with materiality guiding disclosures.
- **Cost Constraint**: Balances information costs against benefits, ensuring practicality.

- **Substance Over Form**: Prioritizes economic reality, countering unethical practices like off-balance-sheet financing (IFRS 15), profit manipulation (Hollywood accounting), and balance manipulation (Ted Baker's inventory overstatement).
- **Theory vs. Practice**: Principle-based IFRS allows judgment, leading to varied applications (e.g., IAS 16) and gaps in emerging areas (e.g., cryptocurrencies).
- **Fair Value (IFRS 13)**: Exit price-based, using Level 1–3 inputs, with concepts like highest and best use and principal market, applied in examples like Exeter's property valuation.
- **Benefits**: Consistency, transparency, and relevance in financial reporting.
- **Limitations**: Subjectivity, reduced comparability, and complexity in fair value applications.

14. QUIZ

The following SBR-style quiz questions test key concepts and applications from the chapter. Answers are provided at the end.

1. **Conceptual Framework Purpose**

   Multiple Choice

   What is the primary purpose of the IASB Conceptual Framework?

   (*a*) To override specific IFRS Accounting Standards.

   (*b*) To assist preparers in developing accounting policies when no standard applies.

   (*c*) To provide mandatory rules for financial statement presentation.

   (*d*) To replace IAS 1 Presentation of Financial Statements.

2. **Elements of Financial Statements**

   Scenario-Based

   Delta Co. enters a five-year lease for equipment, paying $50,000 upfront and $10,000 monthly. Discuss whether the lease creates an asset or liability for Delta Co., referencing the Conceptual Framework's definitions.

3. **Recognition Criteria**

   True/False

   An asset should be recognized even if there is significant measurement uncertainty that renders the information irrelevant to users.

   (*a*) True

   (*b*) False

4. **Fair Value Measurement**

   Calculation-Based

   Gamma Co. holds an investment property (500 sq.m). Recent sales of similar properties are $1,100, $1,120, $1,150, $1,180 per sq.m. Calculate the fair value using:

   (*a*) Mid-value approach.

   (*b*) Average approach.

   Explain which approach is more appropriate if market prices are trending upward.

5. **Unethical Practices**

   Short Answer

   Explain how "Hollywood accounting" violates the principle of substance over form, and discuss its impact on stakeholders.

QUIZ ANSWERS

1. **B**: The Conceptual Framework assists preparers in developing policies when no standard applies, supports IASB standard-setting, and aids interpretation, but does not override IFRS or replace IAS 1.
2. **Asset**: The lease grants a right to use equipment (economic resource, controlled via contract, potential benefits like operational output). **Liability**: Monthly payments create an obligation to transfer resources ($10,000 per month after use); the upfront payment is not a present obligation unless benefits are received. **Conclusion**: Recognize the right-of-use asset and a liability as lease payments accrue, per IFRS 16 Leases and the Conceptual Framework.
3. **B (False)**: Recognition requires relevance and faithful representation; high measurement uncertainty may render information irrelevant, preventing recognition.
4. **a. Mid-Value**: $575,000 (500 × $1,150, median of $1,100, $1,120, $1,150, $1,180). **b. Average**: $562,500 (500 × $1,125, average of all prices). **Explanation**: If prices are trending upward, the highest value ($1,180, yielding $590,000) or a weighted average reflecting recent sales is more appropriate to reflect current market conditions, per IFRS 13.
5. **Violation**: Hollywood accounting misrepresents economic substance by allocating unrelated overheads to report losses, contrary to IFRS 15's revenue recognition principles. **Impact**: Denies stakeholders (e.g., actors) profit shares, erodes trust, misleads investors about financial performance, and risks legal/regulatory consequences.

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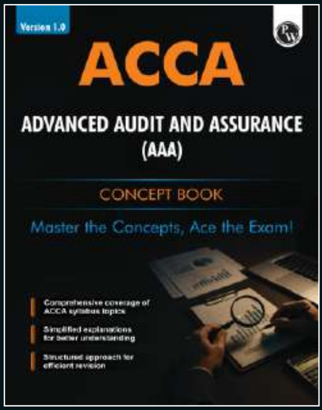

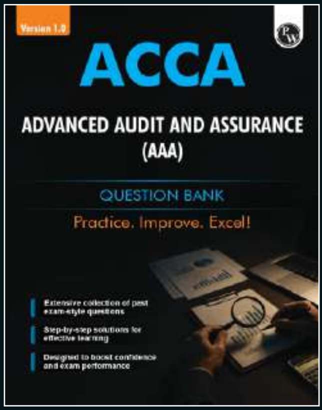

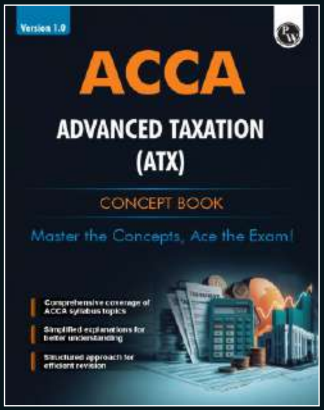

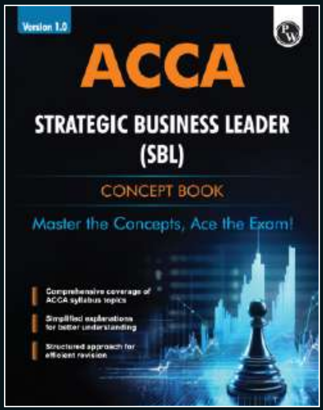

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